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Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain

Donald S. Bernstein

Douglas G. Baird

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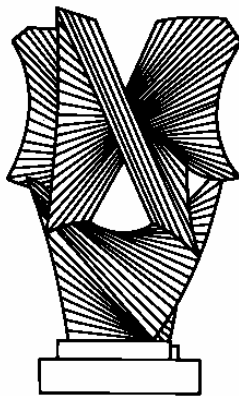
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Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain

Douglas G. Baird^{} & Donald S. Bernstein^{**}*

^{*} Harry A. Bigelow Distinguished Service Professor, University of Chicago.

^{**} Partner, Davis Polk & Wardwell and Chair, National Bankruptcy Conference. Previous drafts of this paper were presented at the annual meeting of the American Law and Economics Association and the Law and Economics Workshop at Boalt Hall. We are grateful to Edward Morrison, Robert Rasmussen, J. Ronald Trost, and Joanna Cohn Weiss for their help. We also thank the Sarah Scaife Foundation and the Russell Baker Scholars Fund for research support.

Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain

Abstract

In a Chapter 11 reorganization, senior creditors are entitled to insist upon being paid in full before anyone junior to them receives anything. In practice, however, departures from such “absolute priority” are commonplace. Explaining these deviations has been a central preoccupation of reorganization scholars for decades. By the standard law-and-economics account, deviations from absolute priority arise because well-positioned insiders take advantage of cumbersome procedures and inept judges. In this paper, we suggest that a far simpler and more benign force dominates bargaining in reorganization cases.

“Deviations” from absolute priority are inevitable even in a world completely committed to respecting priority as long as asset values are uncertain. Uncertainty accompanies any valuation procedure. Bargaining in corporate reorganizations takes place in the shadow of this uncertainty, and standard models of litigation and settlement show that valuation uncertainty alone can explain many of the departures from absolute priority we see in large corporate reorganizations. Even where rational and well-informed senior investors expect the absolute priority rule to be strictly enforced, they must account for the uncertainty associated with any valuation. The possibility of an unexpectedly high appraisal will cause them to offer apparently out-of-the-money junior investors contingent interests in the reorganized business.

The debate over absolute priority, the central principle of modern corporate reorganization law, has been misdirected for decades. It has failed to recognize that a substantive rule of absolute priority does not lead to an absolute priority outcome. A coherent account of absolute priority must incorporate relative priority. It must take account of the option value implicit in the junior investors’ right to insist on an appraisal.

This paper offers an explanation for one of the most important and persistent puzzles in corporate reorganizations. In a Chapter 11 reorganization, senior creditors are, in principle, entitled to insist upon “absolute priority.” They have a right to be paid in full before junior investors receive anything. This “fixed principle” has been the foundation of our corporate reorganization laws for decades.¹ In practice, however, departures from ab-

¹ Case v. Los Angeles Lumber Prod., 308 U.S. 106, 116 (1939) (“This doctrine is the ‘fixed principle’ according to which *Northern Pacific Railway Co. v. Boyd* [228 U.S. 482 (1913)] decided the character of reorganization plans was to be evaluated.”).

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solute priority are commonplace.² Senior creditors regularly allow those junior to them to participate in recoveries even when the senior creditors may not be paid in full. Explaining this gap between law and practice has been a central preoccupation of reorganization scholars since the 1920s.

To most observers, these persistent “deviations” from absolute priority suggest something is seriously amiss. Conventional accounts, particularly in the law-and-economics literature, are replete with finger pointing. Bankruptcy judges are biased or incompetent or in any event powerless to protect the priority of senior investors. Old managers, the representatives of the shareholders, “use their power to run their businesses and to control reorganization agendas to capture portions of the value that creditors are legally entitled to receive.”³ This account, however accurate it may have once been, utterly fails to capture the dynamics of corporate reorganizations today.

The typical modern bankruptcy judge is committed to respecting legal priorities and does not hesitate to entertain a sale of the business as an alternative to reorganizing.⁴ She is far less likely to allow junior investors to play for time or otherwise manipulate the process. Old managers frequently are replaced (often before the Chapter 11 case even begins) with turnaround specialists whose bias, if any, is with the senior investors. Old equityholders, far from controlling the process, typically are wiped out. The contest is between seasoned investors (banks, hedge funds and other institutional investors) who hold debt at different levels of the debtor’s capital structure, none of whom enjoys special sympathy from the judge or anyone else.

² See, e.g., Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457, 1468 (1990) (finding departures in 76% of cases); Julian R. Franks & Walter Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747, 754, 768 (1989); Lawrence A. Weiss, *Bankruptcy Resolution*, 27 J. FIN. ECON. 285, 286 (1990) (finding departures from absolute priority in 78% of the cases). One can posit situations (often involving small businesses in which the owner-managers have private information) in which parties bargain for something other than absolute priority. One can also posit situations (again typically involving small businesses) in which it is not meaningful to talk about an ex ante bargain among all the participants. Such cases, however, are not the norm in the large reorganizations that are the focal point of academic debates either in the 1930s or today.

³ Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1836 n.69 (1998).

⁴ In 2002, 56% of the large Chapter 11 reorganizations resulted in a sale of one sort or another. See Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675 (2003).

The Chapter 11 proceedings of Consecro Corporation offer a good example of how the standard account fails to capture modern reorganization practice. Consecro, one of the largest Chapter 11 debtors ever, was a successful insurance holding company that purchased, for many billions of dollars, a financier of mobile homes. The mobile home business turned out to be worth only a fraction of what Consecro paid for it, and Consecro, after having been successful for so long, proved insolvent. Consecro's founder (as well as his replacement) was fired before the Chapter 11 case even began. The negotiations were between senior banks and bondholders. Equity holders did not play any material role.⁵ Neither creditor group had information the other did not. Neither had any special power over the business or how its affairs were run.

Consecro's senior bank debt amounted to approximately \$2.04 billion.⁶ In the bargaining that ensued, the senior banks agreed to accept notes for \$1.3 billion and callable, convertible preferred stock for the balance of their claims.⁷ The junior bondholders received *substantially all* of the common stock of the reorganized company.⁸ At the time of these negotiations, the

⁵ An official committee representing holders of "trust preferred" securities that were junior to Consecro's bondholders did object to confirmation of the plan embodying the settlement ultimately reached between Consecro's banks and the bondholders. This objection forced the bankruptcy court to hold a valuation trial at which the committee sought to establish that the value of the business was high enough so the trust preferred securities were "in the money." The lengthy confirmation hearing was completed, but before the court ruled, the banks and bondholders settled with the trust preferred holders, offering them a small amount of value, mostly in the form of warrants with a strike price in the money only at high enterprise values. Consecro, Inc., Annual Report (Form 10-K), at 2 (Dec. 31, 2003). This post-trial settlement with the holders of Consecro's trust preferred securities is illustrative of the theme of this paper. It was, in effect, the price the banks and bondholders were willing to pay for an insurance policy against the possibility of an unexpectedly high valuation.

⁶ Consecro's senior bank debt consisted of approximately \$1.54 billion of outstanding loans under a syndicated bank credit agreement and approximately \$500 million associated with Consecro's guarantees of bank borrowings by officers and directors, including in each case unpaid interest through the date on which the chapter 11 proceedings commenced. Consecro, Inc., *Second Amended Disclosure Statement for Reorganizing Debtors' Joint Plan of Reorganization Pursuant to Chapter 11 of The United States Bankruptcy Code*, Case No. 02-49672 (N.D. Ill. Mar. 18, 2003) [hereinafter *Second Amended Disclosure Statement*] at 18-19.

⁷ *Second Amended Disclosure Statement*, *supra* note 6, at Exhibit 2.2; Consecro, Inc., *supra* note 5, at 102.

⁸ *Id.*

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press suggested Consecos was not worth enough to pay the banks in full.⁹ By the standard law-and-economics account, a well-functioning reorganization process in such circumstances would have left junior investors with little or no distributions under a plan of reorganization. In this light, the distributions received by Consecos's junior bondholders seem highly suspect. They appear to represent a "deviation" from absolute priority that the conventional model would attribute to the junior bondholders' ability to delay or otherwise manipulate the reorganization process.

Consecos's junior bondholders, however, did not have any real ability to delay or manipulate the process. They could not do so because, to protect policy holders, insurance regulators were ready to appoint receivers for Consecos's insurance subsidiaries if the companies were not speedily restructured.¹⁰ The appointment of receivers would have meant the profitable insurance subsidiaries would cease to write new policies and would liquidate. The going concern value of the enterprise in excess of its liquidation value would have been lost.¹¹ This left little opportunity for junior investors to delay the day of reckoning.

Consecos is but an extreme example of what is increasingly common in large corporate reorganizations. In most cases, there is a high likelihood that some form of liquidation of the business (usually a going-concern sale) will be imposed on junior creditors if a reasonably prompt reorganization cannot be accomplished.¹² Yet, sophisticated senior investors, facing an impartial bankruptcy judge who holds a tight leash on the process, regularly agree to plans of reorganization that provide for distributions to apparently out-of-the-money junior investors, typically in the form of a residual stub of equity or warrants.¹³

⁹ See, e.g., Floyd Norris & Joseph B. Treaster, *Consecos's Troubles Outlast Reign of a Would-Be Savior*, N.Y. TIMES, October 4, 2002, at C5 (quoting an analyst who said, "We don't think the company can be liquidated for even \$2 billion").

¹⁰ Consecos, Inc., *supra* note 5, at 76.

¹¹ For this reason, among others, scorched earth delaying tactics on the part of Consecos's junior bondholders would have destroyed any prospect of a recovery for them. Indeed, even if a liquidation could have been avoided, a protracted restructuring would have prolonged the period during which the insurance subsidiaries would have continued without restoration of a strong A.M. Best rating. The absence of such a rating would have made it impossible to continue in some policy lines and would have impaired others. The value of the business would have been substantially reduced.

¹² See Baird & Rasmussen, *supra* note 4, at 675.

¹³ Warrants are a common feature of securities issued in large Chapter 11 reorganizations. See Kerry O'Rourke, *Valuation Uncertainty in Chapter 11 Reorganizations*, 2005 COLUM. BUS. L. REV. 403, 431. Recent cases include Exide Technologies, Lodgian, U.S. Airways,

If these outcomes are not driven by junior investors' control of the process, as the standard account would have it, something else must be at work. We believe the standard account ignores something that is quite important, very simple and essentially benign. Applying the absolute priority rule in the context of a corporate reorganization requires the enterprise to be valued. Uncertainties accompany any valuation procedure. These uncertainties affect bargaining over reorganization distributions in ways that can be readily predicted from the standard models of litigation and settlement, and drive negotiated outcomes in many large corporate reorganization cases.¹⁴

In this paper, we show that the uncertainty inherent in valuing a large corporation in financial distress creates a bargaining dynamic that accounts for many of the "puzzling" departures from absolute priority that cannot be explained by the standard model.¹⁵ "Deviations" from absolute priority are

Pillowtex, Weblink Wireless, Sun HealthCare Group, and Factory Card Outlet Corp. *See* EXIDE TECHNOLOGIES, EXIDE TECHNOLOGIES ANNOUNCES FIRST QUARTER OF FISCAL 2005 EARNINGS RESULTS, Aug. 12, 2004, http://www.exideworld.com/News/pressrelease/financial/20040812_1qfy05_earnings_results.html; Disclosure Statement for Joint Plan of Reorganization of Lodgian, Inc., et al. (other than the CCA Debtors), together with the Official Committee of Unsecured Creditors under Chapter 11 of the Bankruptcy Code, dated as of September 5, 2002, at 25-27; First Amended Joint Plan of Reorganization of US Airways Group, Inc. and Its Affiliated Debtors and Debtors-in-Possession, dated January 17, 2003, at Exhibit L; Disclosure Statement with Respect to First amended Joint Plan of Reorganization of US Airways Group, Inc. and its Affiliated Debtors and Debtors-in-Possession, dated January 17, 2003, at 54-55; Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code for the Second Amended Joint Plan of Reorganization of Pillowtex Corporation and its Debtor Subsidiaries, March 6, 2002, at 67-68; Second Amended Plan of Reorganization of Weblink Wireless, Inc., Pagemart PCS, Inc., and Pagemart II, Inc. under Chapter 11 of the Bankruptcy Code, dated July 15, 2002, at Exhibit G; In re Sun Healthcare Group, Inc., Disclosure Statement for Debtors' Joint Plan of Reorganization, dated Dec. 18, 2001, at 24-25; and In re Factory Card Outlet Corp., and Factory Card Outlet of America LTD., Debtors' Joint Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code, dated Feb. 5, 2002, at 36.

¹⁴ The reorganization of Loral is a typical recent example. A leading satellite communications company had some assets that could be (and were sold) for more than a billion dollars. However, there was not a liquid market for the remaining assets (which included everything from orbital slots to real estate to disputes with insurers to unfulfilled contracts to launch new satellites). Valuation of Loral's assets accordingly became the single issue coloring the entire case. See, e.g., *Loral Skynet CEO Details Post-Chapter 11*, SATELLITE NEWS, Oct. 4, 2004; John Russell, *Loral Shareholders Want Investigation; They Claim Bankrupt Firm Is Not Insolvent*, AKRON BEACON J., Aug. 8, 2004, at D1; Lou Whiteman, *Intelset Wins Loral Satellite Auction*, DAILY DEAL, Oct. 21, 2003.

¹⁵ When possible, of course, we want to avoid such valuation problems by using markets to establish value. Modern bankruptcy practice in fact frequently takes advantage of

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in fact nothing of the kind. They are rather the natural product of bargaining in a world that is completely committed to respecting priority but in which values are uncertain. Critics of Chapter 11 have assumed that a substantive right to enjoy absolute priority should lead to outcomes that also reflect absolute priority. This is a mistake. Those participating in the modern debate over corporate reorganizations took the wrong path because they have insisted on seeing something—an absolute priority outcome—that should not be there in the first place. Ironically, while the academy has neglected the way in which valuation uncertainty affects the dynamics of bargaining in Chapter 11, practitioners have long identified it as the principal challenge to resolving corporate reorganizations.¹⁶

In Part I of this paper, we review the absolute priority rule and the standard explanations for “deviations” from it offered in the law and economics literature. We suggest why these explanations fail to completely account for the outcomes we see in the reorganization of large, publicly traded, businesses. In Part II, we describe the context in which a large business typically is reorganized in Chapter 11 today. In Part III, we lay out the bargaining dynamics created by valuation uncertainty and explain how those dynamics account for many of the “deviations” from absolute priority commonly seen in large reorganization cases. In Part IV, we discuss the implications of our analysis for the form of the negotiated outcomes we see in reorganization cases. In Part V, we conclude by connecting our observations to the longstanding debate in corporate reorganization law over the optimal distribution rule — the choice between relative and absolute priority—a debate joined by two legal scholars, James Bonbright and Milton Bergerman, in 1928¹⁷ and which has been raging ever since.

markets. More than half of the large businesses that enter Chapter 11 go through an asset sale rather than a reorganization. In recent years, these have included, to name a few, Enron, Fruit of the Loom, TWA, Budget Rent-A-Car, and Global Crossing. See *In re Trans World Airlines, Inc.*, 2001 WL 1820326, at *4 (Bankr. D. Del. Apr. 2, 2001); Baird & Rasmussen, *supra* note 4, at 676-77, 681-82 & n.31, 698 & n.68. The cases that are left are precisely those where the market is illiquid or, as discussed further below, where the debtor’s stakeholders believe the market does not attribute adequate value to the business. In such circumstances, investors as a group are better off foregoing a market sale until after the reorganization is over. Consecro and Worldcom (renamed MCI) provide recent illustrations of such cases. See *supra* notes 5-13 and accompanying text; Ken Belson & Matt Richtel, *Qwest Quits Bid for MCI as Verizon Raises Offer*, N.Y. TIMES, May 3, 2005, at C5.

¹⁶ See, e.g., Peter F. Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 CASE W. RES. L. REV. 301, 314 (1982).

¹⁷ See generally James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127 (1928).

I.

Absolute Priority in Theory and in Practice

A single engine drives law-and-economics accounts of corporate reorganization. The reorganization of an insolvent enterprise is the equivalent of a going concern sale of the business to its creditors in exchange for their claims.¹⁸ The business has an uncertain future. It is like a lottery ticket before a drawing.¹⁹ While there is a chance that it may do well, there is also a chance that it will do poorly. At the time this “lottery ticket” is “sold,” it must be valued for purposes of allocating interests in it among its new owners (the creditors).²⁰ This valuation necessarily collapses all future possibilities to a present value, and, absent agreement of the requisite majorities of each impaired class of creditors, the valuation dictates how interests in the reorganized enterprise must be allocated to satisfy the absolute priority rule.

Assume that the debtor’s business will be worth \$200 or \$100 in a year’s time with equal probability. The senior investor is owed \$160 and the junior investor \$40. At a going concern sale, the senior investor should, in theory, be able to sell the business for \$150 (less a discount for the time value of money), the amount that reflects both the probability that the business will do well and that it will fail. Because the senior investor is owed \$160, its priority should entitle it to the entire \$150 generated in the sale. Hence, it should receive the value of the entire business in any plan of reorganization that respects the absolute priority rule.

Some law-and-economics accounts of “deviations” from absolute priority focus on private information and firm-specific human capital. These models, however, are not relevant here. Departures from absolute priority can be justified if junior investors run the business and possess private information or firm-specific human capital.²¹ In such circumstances, a portion

¹⁸ THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW*, 210-213 (1986).

¹⁹ See, e.g., Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 474 (1992). In other work, however, Adler is quick to identify the bargaining dynamics that are our central concern here. See Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INSTITUTE L. REV. 219, 226-29 (2004).

²⁰ Among themselves, the “purchasers” relative entitlements are established by their ex ante bargain, as reflected in their nonbankruptcy entitlements rights against the debtor.

²¹ See, e.g., Paul Povel, *Optimal ‘Soft’ or ‘Tough’ Bankruptcy Procedures*, 15 J.L. ECON. & ORG. 659 (1999); Robert Gertner & Randal C. Picker, *Bankruptcy and the Allocation of Control* 12-13 (1992) (unpublished manuscript); Lucian Ayre Bebchuk & Randal C. Picker, *Bankruptcy Rules, Managerial Entrenchment, and Firm-Specific Human Capital* 2-3 (University of Chicago, John M. Olin Law and Economics Working Paper No. 16, 2d Series,

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of the value of the business may be inextricably linked to the participation of the junior investors.²² In the case of smaller businesses, the junior investors, who may well be the managers of the firm, often possess just such characteristics. Allowing them to participate in reorganization distributions, even if, as investors, they are “out of the money” as a matter of strict legal priority, often is a price senior investors are willing to pay to ensure their cooperation. Such a justification does not, however, typically apply to larger companies. The managers are professions who can be and are frequently replaced, sometimes even before the Chapter 11 case is filed and equity-holders commonly are wiped out.²³ Moreover, pre-bankruptcy boards of directors, sooner or later, are replaced.²⁴

Restructuring negotiations in Chapter 11 cases today take place primarily between senior and junior creditors, none of whom has participated in running the business. Trading of claims in advance of Chapter 11 or shortly afterwards typically ensures that these groups consist of seasoned professionals who specialize in recapitalizing distressed businesses.²⁵ In connection with the reorganization process, these parties learn more about the business than the outside world knows, but neither has an informational advantage vis á vis the other.²⁶ Models that depend upon private information or firm-specific human capital to explain departures from absolute priority thus have no role to play.

To explain deviations from absolute priority in the absence of private information or firm-specific human capital, the standard account posits that

1993), available at http://www.law.uchicago.edu/Lawecon/WkngPprs_01-25/16.Bebchuk-Picker.pdf.

²² See Bebhuk & Picker, *supra* note 21, at 2-3.

²³ See Baird & Rasmussen, *supra* note 4, at 692 n.65.

²⁴ Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. ____ (forthcoming 2006).

²⁵ Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 181 (2004) (noting that “distressed debt trading has grown to proportions never contemplated at the time of the enactment of the Bankruptcy Reform Act”); Glenn E. Siegel, *Introduction: ABI Guide to Trading Claims in Bankruptcy: Part 2 ABI Committee on Public Companies and Trading Claims*, 11 AM. BANKR. INST. L. REV. 177, 177 (2003) (“Perhaps nothing has changed the face of bankruptcy in the last decade as much as the newfound liquidity in claims. . . . Now, in almost every size case, there is an opportunity for creditors to exit the bankruptcy in exchange for a payment from a distressed debt trader . . .”). See generally Paul M. Goldschmid, Note, *More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191 (2005).

²⁶ See *infra* note 77.

the Chapter 11 process itself is defective. It permits junior creditors to interfere with the senior creditors' right to insist on an accurate valuation. If junior investors are aware that an accurate valuation—one that reflects what a sale in the marketplace will yield—will afford them little or no recovery, they will seek to put off the day of reckoning. If they can delay a sale (or any other accurate valuation mechanism), they have a chance of recovery. Returning to the metaphor of the lottery ticket, they would prefer to play the odds rather than value the ticket based on probable outcomes. If, after some time passes, the lottery ticket proves a loser, they still receive nothing. But if it proves a winner, there will be \$200 to be divided. After the senior investors receive the \$160 they are owed, there is still enough to make distributions to junior investors.

The ability of junior investors to postpone the day of reckoning gives them bargaining power by imposing transaction and opportunity costs on senior investors and by preserving the possibility that the lottery ticket may prove to be a winner before the allocation of distributions is decided. If junior investors have the power to delay, it should lead to plans of reorganizations that deviate from absolute priority. Senior creditors will agree to accept less than their apparent legal entitlements because of the costs delay would impose upon them and because of the option value junior investors have as a result of their ability to delay.

There are a number of ways junior investors may seek to delay the day of reckoning and increase their chance of being paid. They can seek to cause the debtor to delay introduction of a plan of reorganization while the court maintains the debtor's exclusive period to file a plan.²⁷ They can seek to use the resources of the debtor to finance an attack (however remote the likelihood of success) on the priority position of the senior investors.²⁸ They can seek to prevent other steps, such as a shutdown of the business or an asset sale, that will monetize the value of the business.²⁹ In addition, because it involves no cost to them, they can seek to cause the debtor to de-

²⁷ For Chapter 11 cases commencing after October 17, 2005, the availability of such extensions has been limited to 18 months following the petition date by recent amendments to the Bankruptcy Code. S. Res. 256, 109th Cong. (2005) (to be codified at 11 U.S.C. § 1121(d)(2)).

²⁸ See Arturo Bris et al., *Who Should Pay for Bankruptcy Costs?* 2-4 (Yale Law School, Center for Law, Economics, and Public Policy Research Paper No. 277, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=401300.

²⁹ See JACKSON, *supra* note 18, at 216 ("Any event that fixes value today, such as a sale of assets . . . leaves [shareholders] with nothing as their baseline entitlement. When a group has nothing to lose by delay, that group will in fact favor delay.").

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ploy its capital on speculative ventures to generate value.³⁰ To the extent these tactics are successful, the senior investors bear the costs of delay (in terms of both expense and opportunity cost) while the junior investors reap the benefits.

By this account, senior investors have difficulty defeating junior investors' delaying tactics because the debtor's managers often cooperate with the junior investors, making it difficult for the senior investors to force a sale or some other process that values the assets accurately. Bankruptcy courts are thought complicit in these tactics because of their historical tendency to grant repeated extensions of the debtor's exclusive period to file a plan.³¹ Moreover, once a plan is filed, and even though an unbiased valuation at market would give senior investors the entire business, bankruptcy judges, it is said, resist markets and mechanisms that mimic them, often adopting a peculiarly rosy view of the world. "Reorganization value" is not construed as what the enterprise would fetch in the marketplace, but the value of the enterprise if things turn out as hoped. The lottery ticket, in other words, tends to be valued closer to \$200, its value if it proved a winner, rather than \$150, the value accurately reflecting both the upside and the downside.³²

³⁰ See Adler, *supra* note 19, at 448 ("If equity can control the firm, moreover, it can increase the risk of the debtor's investments....").

³¹ See James J. White, *Harvey's Silence*, 69 AM. BANKR. L.J. 467, 474 (1995) ("[T]he largest and most palpable costs of Chapter 11 arise from delay. . . . Chapter 11—at least as practiced in large cases—appears to condone and even exaggerate delay and the attendant costs. For example, Eastern Airlines lost \$600 million during the twenty-two months it lingered in Chapter 11. LTV continued in bankruptcy from July, 1986, to May, 1993, and during most of that time incurred losses. Countless other smaller and nameless Chapter 11's—as many as ninety percent—have this attribute; namely, they are businesses that must ultimately be liquidated, but it takes as long as eighteen months on average to accomplish liquidation. And during every one of those 550 days in bankruptcy, many, perhaps most, of these firms are experiencing losses and postponing the day when their assets can be allocated to better and more efficient purposes. The costs of delay are palpable and indisputable.").

³² Some argue that the result in the recent Exide Technologies case, *In re Exide Technologies*, 303 Bankr. 48 (D. Del. 2003), supports this proposition. The judge valued the business in a way that imputed a value of \$24.50 per share to the new equity when the business emerged in Spring 2004 and the equity is now trading for less than \$5. See, e.g., O'Rourke, *supra* note 13, at 406. The stock, however, traded close to the judicial valuation at first. In any event, our principal claim is not that bankruptcy judges are necessarily as good as unbiased experts, only that valuation variance is a persistent and pervasive problem that any theory of absolute priority must take into account. If we relax the assumption that bankruptcy judges have financial expertise equivalent to an expert appraiser and also recognize that the expert "hired gun" testimony presented to the court by opposing litigants is likely itself to be biased toward the extreme ends of the range of variance, it can be

In short, the standard law-and-economics model of corporate reorganizations rests, to a very large extent, on the assumption that out-of-the-money junior investors retain excessive influence over the Chapter 11 process. Bankruptcy judges give lip service to the dictates of absolute priority, but they lack the discipline, the training, or the inclination to rein in junior investors and value assets accurately and expeditiously. To be sure, the senior and junior investors can reach a deal with each other to prevent the needless dissipation of assets. Nevertheless, these “deviations” from absolute priority are still costly. A world in which absolute priority is not respected is one in which entrepreneurs will have less access to capital. Prospective investors take the dynamics of Chapter 11 into account and either refuse to lend or demand higher rates of interest. Some projects with a positive expected value will not be funded.³³

If the standard model captures what is going on in large Chapter 11 reorganizations, a number of reforms seem sensible. For example, procedures could be imposed that ensure a swift day of reckoning, such as an immediate sale in the market or a process that forces junior investors to buy out the seniors as a condition of maintaining their interests.³⁴ At a minimum, provisions should be added to Chapter 11 that force plan negotiations to conclusion at an earlier date.³⁵

The standard model, however, cannot be squared with modern Chapter 11 practice in large cases. Contrary to the assumption that junior investors hold the levers of power, senior investors are increasingly successful at insisting upon a relatively speedy day of reckoning. Assets sales are commonplace. We see them in more than half the cases, and they are the benchmark against which consensual plans are measured in the rest.³⁶ Where the business is not sold, many Chapter 11 cases involve prepackaged or pre-negotiated reorganization plans where junior investors’ delaying tactics are not a serious factor, and even when values are disputed and a bankruptcy

expected that the variance associated with judicial appraisals will be larger than that associated with the appraisal of an independent expert. A certain fraction of the time this will lead to outcomes at the extreme ends of the variance range without any systematic bias on the part of the judiciary. *See infra* note 86.

³³ *See* Schwartz, *supra* note 3, at 1814 (1998).

³⁴ *See, e.g.,* Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523, 524, 532-36 (1992). *See generally* Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988).

³⁵ This was part of the rationale for the recent Bankruptcy Code amendments limiting extensions of the debtor’s exclusive period to file a plan. *See supra* note 27.

³⁶ *See* Baird & Rasmussen, *supra* note 4, at 679.

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judge is called upon to value the debtor's business, there is less systematic bias today than the traditional account suggests.³⁷

A crucial element of the bargaining dynamic has been overlooked. The valuation problem in a reorganization case is crucially different from the one associated with valuing a lottery ticket. While there is no way to know whether a lottery ticket will prove a winner, the probabilities and the payoffs are known and agreed upon by all parties. Given the relevant information, risk-neutral investors will place the same value on the lottery ticket. Collapsing future possibilities to present value yields a sum certain. Valuing a business, on the other hand, is not as simple as valuing a lottery ticket. Unlike a lottery ticket with known probabilities and payoffs, when it comes to valuing a business, well informed and equally sophisticated parties can have different perspectives regarding the likelihood of different value outcomes. For example, two equally sophisticated investment bankers can be in honest disagreement over the value of a business. Differences of ten or twenty percent are commonplace.³⁸ This range of valuation perspectives is the dominant feature of the problem we face in valuing a business, especially a business in economic distress.

A market transaction (sale) resolves such differences in valuation perspective by rewarding the highest bidder with ownership of the asset. It is highest bidder's perspective that counts. In the absence of a market transaction in a reorganization case, however, it is the bankruptcy judge's perspective—and how senior and junior investors perceive it—that counts. Their potentially very different assessments of the judge's ultimate valuation drives bargaining behavior. For this reason, starting with the equivalent of a lottery ticket to model corporate reorganizations—as virtually all of the law and economics literature does in one way or another—is seriously incomplete. Such models assume that differences in valuation perspectives can safely be ignored, that they do not affect the dynamics of Chapter 11 reorganizations in an important way. They cannot be. Disparities in investors' views over how to value the enterprise and in their views of how the judge will value it drive much of the bargaining in large reorganization cases and

³⁷ Our model allows for the parties to assess valuation bias in determining probabilities of various value outcomes. To the extent such bias remains and is affecting settlements, reforms might well be warranted.

³⁸ As Fischer Black famously observed, "All estimates of value are noisy." See Fischer Black, *Noise*, 41 J. FIN. 529, 533 (1986). Indeed, Black showed that without such valuation uncertainty, securities markets could not even exist. For him, a market was efficient if the price at which a security traded is somewhere between half and twice its true value. *Id.* For an example of a reorganization case in which the problem of valuation is discussed extensively, see *In re Exide Technologies*, 303 Bankr. 48, 70-71 (D. Del. 2003).

account for many of the departures we see from absolute priority. Such disparities also explain why the bargains ultimately struck between senior and junior investors (providing for a payout to junior investors that has value only if the business does well) take the form that they do.

Once the impact of the uncertainties associated with appraising the value of the enterprise are recognized, reforms that seek to ensure closer adherence to the absolute priority rule appear less urgent. Apparent departures from absolute priority can be seen as inevitable features of negotiations conducted in the shadow of the absolute priority rule because, in the context of a reorganization, the rule itself must rely for its enforcement on non-market based valuation mechanisms. One can press for greater use of markets, but there is little evidence that Chapter 11, as currently practiced in large cases, fails to make sufficient use of markets: if creditors desire to reorganize the enterprise rather than sell, they have concluded the enterprise is worth more to them than the market will bring. From this perspective it would appear that many, if not most, so-called “deviations” from absolute priority—the most often-voiced weakness of Chapter 11—are greatly overstated, if not illusory.

II.

Two Chapter 11 Prototypes: Sale or Reorganization

Several distinct patterns mark modern large business reorganization practice. The major divide is between those cases in which there is a sale of the business (or its assets) to a third party and those in which the business is reorganized, with existing investors becoming the owners of reorganized enterprise.³⁹ Where the business is sold to a third party, outcomes are, to a very large extent, consistent with absolute priority as traditionally understood. Where the business is reorganized, the right to insist on a judicial valuation in connection with enforcement of the absolute priority rule is a prominent feature of the bargaining dynamic. It is here that bargained-for deviations from absolute priority most often appear and must be accounted for. We examine each of these prototypes in turn.

³⁹ As others have observed, as with a sale, a reorganization is nothing more than a change of control transaction—a sale of the business to the creditors. *See, e.g.,* Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238, 1250-54 (1981). Under this view, the majority voting provisions of Chapter 11 might be considered the shareholder governance provisions of an acquisition vehicle called the debtor-in-possession. By permitting the majority of each class of creditors to bind the majority, the provisions of Chapter 11 solve a collective action problem within the acquiring (creditor) group. For the classic exposition of reorganization law as a solution to a collective action problem, see Thomas H. Jackson, *Bankruptcy, Nonbankruptcy Entitlements and the Creditors' Bargain*, 91 YALE L.J. 857, 860-65 (1982).

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Sale of the Distressed Business in Chapter 11

Sales of operating businesses in Chapter 11 are commonplace. This is true even in very large Chapter 11 cases—cases involving businesses that, in a prior era, were thought to be too large to be readily sold. A Chapter 11 sale can take a number of different forms and the timing can vary. Sometimes, as in the case of U.S. Office Products, negotiation of the sale of the debtor's core businesses (its office products business and its *Mailboxes, Etc.* subsidiary) is largely completed before the commencement of Chapter 11 proceedings. In such cases, sales are consummated within weeks of the company's Chapter 11 filing. In other cases, like that of Bethlehem Steel, the business may remain in Chapter 11 for an extended period before being sold.⁴⁰

A sale of the troubled business or its assets is often the only logical course. This is especially so when the debtor's operations are losing money, even before debt service.⁴¹ Consider Qualitech Steel.⁴² Qualitech Steel was formed in 1996 to exploit new technologies for producing specialty steels. Its two plants cost more than \$400 million. They took longer to build and were more costly to construct and operate than expected, and generally performed below expectations. When it entered Chapter 11, Qualitech owed secured lenders about \$265 million and it was losing \$10 million a month.⁴³ Everyone recognized from the outset that the plants had to be sold promptly, either to an established producer or to someone willing to take considerable risk in an effort to get the plants working to original hopes.

⁴⁰ Bethlehem's ongoing operations were sold 18 months after commencement of its Chapter 11 proceedings. *See, e.g.*, Press Release, International Steel Group, International Steel Group Completes Purchase of Bethlehem Steel Assets (May 8, 2003), *available at* <http://www.intlsteel.com/Press/15.pdf>; *Bethlehem Steel Petitions for Chapter 11 Bankruptcy*, BUFFALO BUS. FIRST, Oct. 16, 2001, *available at* www.bizjournals.com/buffalo/stories/2001/10/15/daily5.html?t=printable.

⁴¹ A case in which substantially all of the debtor's assets are encumbered by liens exceeding the value of those assets is usually referred to as an "administratively insolvent" case. The estate has no free assets to cover administrative expenses or to provide the secured lender with adequate protection for the use of the secured lender's collateral. Because the Bankruptcy Code prohibits the use of cash collateral without providing adequate protection to the secured creditor or obtaining the secured creditor's consent, see 11 U.S.C. §363(c)(2) (2004), the secured creditor usually is in a position to insist upon a sale of the business in the administratively insolvent case.

⁴² *See In re Qualitech Steel*, 276 F.3d 245 (7th Cir. 2001); *Mellon Bank v. Dick Corp.*, 351 F.3d 290 (7th Cir. 2003).

⁴³ *See id.* at 291; Bill Koenig, *Banks Get OK to Take Qualitech*, INDIANAPOLIS STAR, July 20, 1999, at 01C.

Within six months, all of Qualitech's operating assets were sold for less than \$230 million.⁴⁴

Under the rule of absolute priority, Qualitech's equityholders should have been wiped out completely, and they were.⁴⁵ Indeed, in the great majority of large Chapter 11s today, equity is wiped out.⁴⁶ Under absolute priority, however, Qualitech's unsecured creditors also should have received nothing. Once the debtor's estate was reduced to cash by a sale, a bright line was established between those who were in the money (the secured lenders) and those who were not (everyone else). In Qualitech, however, this did not happen. The secured lenders agreed to a plan in which \$7.5 million was distributed to unsecured creditors. Given the millions the secured lenders stood to lose every month if the company was not sold, the ability of unsecured creditors to delay the consummation of the sale by even a few weeks gave them negotiating leverage to extract a payment.⁴⁷

Leverage of this type varies, as a practical matter, from one bankruptcy case to another depending on the facts of the case and the tolerance of the court for litigiousness and delaying tactics. In cases where the business cannot be operated profitably, merely the amount of time that a bankruptcy judge takes to hear and resolve a contested motion can have a significant effect on the senior creditors' recoveries. The senior creditors will receive less because of continuing losses suffered by the business, a reduction in its sale value during the period of delay, or even the loss of the opportunity to sell the business at all. The present value of the proceeds available to the senior investors will be less if consummation of the sale is delayed.

⁴⁴ Bill Koenig, *Banks Get OK to Take Qualitech*, THE INDIANAPOLIS STAR, July 20, 1999, at 01C.

⁴⁵ See *Qualitech*, 276 F.3d at 246-47.

⁴⁶ During the early years after enactment of the Bankruptcy Code in 1978, it was commonplace in large reorganization cases for pre-bankruptcy equity holders to retain a small residual interest in the reorganized company despite being out-of-the-money from an absolute priority point of view. See Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 143 (1990). This practice has diminished in recent years. See Baird & Rasmussen, *supra* note 4, at 692 n.65.

⁴⁷ The outcome in U.S. Office Products was similar to the outcome in Qualitech. In U.S. Office Products, the major junior creditors agreed to support the orderly sale of the debtors' businesses, and received a small portion of the proceeds of sale after the payment of administrative expenses. See, e.g., Katie Anderson, *Court OKs US Office Liquidation*, DAILY DEAL, Dec. 13, 2001; Katie Anderson, *Most US Office Creditors Want Liquidation*, DAILY DEAL, Dec. 10, 2001.

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Departures from absolute priority in such cases are, however, diminishing over time.⁴⁸ In the first 10 years after enactment of the Bankruptcy Code, bankruptcy judges often permitted out-of-the-money classes to abuse the bankruptcy process through delay.⁴⁹ Because bankruptcy judges today appear to have diminishing patience with stalling tactics, it is increasingly difficult for out-of-the-money classes to stand in the way of a sale of the business, and the prospect of a sale—a market transaction that crystallizes the rights of creditors and determines whether junior creditors are entitled to receive anything—casts a harsh light on dilatory tactics. This is especially so where it is obvious that a sale will bring the most value for the business. Simply stated, the hold-up power of out-of-the-money junior classes accounts for fewer unjustified departures from agreed-upon priorities than it did in the past.

More interesting than the hopelessly unprofitable, administratively insolvent debtor is the debtor that is profitable on an operating basis (before the cost of servicing its pre-bankruptcy debts). Such a company can survive on its own if it can reduce its debt load by reorganizing. The debtor has free cash flow and the enterprise may have value well in excess of the secured creditors' claims. Under such circumstances, the secured creditors' ability to insist upon a sale in Chapter 11 is significantly diminished. Among other things, the secured creditor's consent may not be required to use cash collateral because the debtor may be able to provide substitute collateral as "adequate protection."⁵⁰ Because the operations are profitable, the representatives of the key creditor constituencies (both senior and junior) have the time to take stock of the debtor's circumstances (either before or after

⁴⁸ Baird & Rasmussen, *supra* note 4, at 692 n.65. Earlier studies suggested that in the 1980s this was not the case. See Jagdeep S. Bhandari & Lawrence A. Weiss, *The Untenable Case for Chapter 11: A Review of the Evidence*, 67 AM. BANKR. L.J. 131, 131 n.12 (1993).

⁴⁹ Bankruptcy Courts have regularly been criticized for the extended duration and excessive cost of Chapter 11 cases. The Chapter 11 of Eastern Airlines is perhaps the most cited example. See generally, e.g., Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKR. DEV. J. 319 (1991). Among other things, it has been suggested that bankruptcy courts have permitted excessive extensions the debtor's exclusive period to file a plan or reorganization. See White, *supra* note 31, at 474.

⁵⁰ A Chapter 11 debtor may not use a secured creditor's cash collateral unless it obtains the secured creditor's consent or can demonstrate that the secured creditor will be "adequately protected" within the meaning of Section 361 of the Bankruptcy Code. 11 U.S.C. §363(c) & (e) (2004). If the debtor has free assets to pay administrative expenses and provide adequate protection, it should be able to use cash collateral (or obtain debtor-in-possession financing) without the secured creditor's consent. In the typical case, an adequate protection package is negotiated and consent is granted.

the commencement of Chapter 11 proceedings). After doing so, they still may conclude a sale is appropriate, or they have the option of reorganizing.

Sometimes a prompt bankruptcy auction will yield a greater value for the business than any other alternative in the foreseeable future. Chapter 11 may, for example, create the possibility of a sale to a buyer willing to pay a control premium for the distressed enterprise that would not have been available outside of bankruptcy. The bankruptcy process can ensure that the buyer will receive clean title, free and clear of pre-bankruptcy claims. Where the parties believe value can be maximized through a Chapter 11 sale, all of the in-the-money classes—both senior and junior—may well support a sale. In the Chapter 11 proceedings of Budget Rent-A-Car, for example, the junior creditors were the ones pushing for a sale to Avis. The majority of Budget's unsecured creditors were strong supporters of the deal.⁵¹ The sale to Avis generated a premium commonly seen in corporate control transactions outside of bankruptcy and left the general creditors with more than a traditional reorganization would have. Similarly, in Adelphia Communications, it was the junior investors who initially pressed for a sale because they believed it would give them more than they would have received under a proposed plan.⁵²

The Reorganization Alternative

Chapter 11 was not, of course, designed with the principal purpose of facilitating sale of the distressed business. It was designed instead to facilitate reorganization. Despite the increasing ease with which even the largest businesses can be sold and the greater prevalence today of Chapter 11 sales, in a substantial number of Chapter 11 cases the business is not sold. The failure to sell increasingly reflects not the commandeering of the reorganization by those who would likely prove to be out-of-the-money in the event of a sale, but rather the quite plausible belief on the part of creditors who view themselves to be in-the-money that owning the enterprise will pro-

⁵¹ It makes sense for unsecured creditors, or even equity holders, to push for a sale if they believe the bankruptcy process will undervalue the company and reward senior creditors with ownership rights in excess of their entitlements. In Budget's case, some of its unsecured creditors even considered signing a lock-up agreement with Avis before the petition date committing themselves to supporting the sale. *See* Baird & Rasmussen, *supra* note 4, at 693 & n.68. However, they did not sign such an agreement. Signing might disqualify them from service on the creditors' committee. By being on the creditors committee, they would be more likely to be able to ensure that the sale would go through.

⁵² *See Creditors Devise Fallback Plan If Adelphia Assets Aren't Sold*, N.Y. TIMES, Nov. 10, 2004, at C4; *Adelphia Creditors Submit Own Reorganization Plan*, AP ALERT COLO., Nov. 9, 2004.

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mote their interests more than a sale.⁵³ Sometimes the senior creditors and the junior creditors agree that the time is not ripe for a sale of the business and both prefer to reorganize. Other times they disagree, with the senior creditors preferring a sale (or, as in cases such as Adelphia Communications, the junior investors preferring one). Either way, the reorganization option is squarely on the table. It is to this situation that we now turn.

While sales are increasingly commonplace in Chapter 11, a significant number of businesses – especially larger ones – continue to reorganize. Some bargained-for departures from absolute priority in these cases are like the ones we saw in Qualitech and U.S. Office Products and are based primarily on “hold-up” value. Even where there is no real dispute that the senior claims exceed the value of the enterprise, junior creditors may extract a token settlement by greasing the skids (or declining to stand in the way) of speedy confirmation of a plan of reorganization. Where, however, there is a range of values a judge might place on the enterprise, creating a possibility that junior investors could be found to be in-the-money, the dynamics are totally different. The simplest way to illustrate these dynamics is through a hypothetical fact pattern that captures the essential features of a modern reorganization case where there is no going-concern sale or prenegotiated Chapter 11 plan.

A Hypothetical Reorganization: American Instruments Corporation

Founded in 1911 as a business that provided instruments for the automobile industry, American Instruments Corporation made speedometers and fuel gauges. It was the primary supplier for Dodge, Chrysler, and many of other automobile manufacturers of the era. American Instruments also designed instruments for aircraft, and over time these became its principal focus. The company survived the Great Depression, flourished during the Second World War and the growth in civilian aviation afterwards. It navigated the changes to instruments that relied increasingly on transistors and other electronic components during the 1960s and 1970s. Its sales reached \$100 million a year in 1980 and approached \$500 million by the end of the 1990s.

⁵³ Adelphia Communications is an example of a case in which the junior classes pushed for a market sale. See Peter Thal Larsen, *Adelphia Puts Itself Up for Sale: Cable Company Fails to Persuade Creditors and Shareholders to Accept Independence Plan: Time Warner, Cox and Comcast Likely Bidders*, FIN. TIMES, April 23, 2004, at 15.

This perhaps reflects a change in attitudes for senior creditors who today analyze the reorganize or sell decision the way a private equity investor might. This change in attitudes is explained in part by changes in the composition of the typical senior creditor group (increasingly hedge funds) as well as changes in the business model of traditional senior creditors (banks).

In 1999, American Instruments acquired US Gauge, a business that specialized in building remote sensors, for \$450 million. The synergies seemed obvious. US Gauge was a relative newcomer. (A group of engineers from Hewlett Packard started the business in the early 1980s.) While its annual revenues were still less than \$100 million, its proprietary sensor technology seemed to be the wave of the future. New fuel efficiencies and the introduction of fly-by-wire technology required many more remote sensors in modern aircraft, and US Gauge's designs defined the cutting edge. US Gauge's technology and American Instruments' customer base and established product lines made the two a natural fit.

To fund its acquisition, American Instruments borrowed \$250 million from a consortium of banks. It raised an additional \$200 million through a high-yield bond offering. In conjunction with the acquisition, American Instruments changed its corporate structure. First, it formed a wholly owned subsidiary, American Instruments Operating Co. All of its operating assets were placed in this subsidiary, as well as all the assets of US Gauge. The bank loan was made to the operating subsidiary, but the banks also obtained a guarantee from the parent company. The loan was secured by a lien on all of the assets of the operating company, including all the debtor's personal property (inventory, equipment, receivables and intangible rights, including intellectual property), as well as all of its property, plant and fixtures, and the guarantee was secured by a lien on the parent's stock in the subsidiary. Interest on the loans was payable monthly, based on a floating interest rate. The bonds were obligations exclusively of the parent company and the bonds were contractually subordinated to the bank's guarantee from the parent.⁵⁴ The bonds required the parent company to pay interest semi-annually at a fixed rate.

Apart from the obligations to the banks and the bondholders, American Instruments has no other borrowings. The operating subsidiary incurs many obligations in the course of its operations, such as to employees, vendors, counterparties to executory contracts and leases, and governmental entities (principally for taxes). American Instruments has no mass tort liabilities, environmental liabilities, pension liabilities or other extraordinary

⁵⁴ In this case, the subordination agreement contains absolute blocks on payments on the bonds after a default on the bank debt until the bank debt is paid in full in cash. Other types of subordination agreements exist. For example, some have a block that is limited in duration unless insolvency proceedings are commenced with respect to the debtor. Yet others may permit the subordinated debt to retain distributions, even in bankruptcy, if the form of such distributions consists of securities that are junior to the securities received by the senior creditors. This latter provision is often referred to as an "X clause" because it is an exception to strict subordination. For a discussion of "X clauses" and their implications, *see* *In re Envirodyne, Inc.*, 29 F.3d 301 (7th Cir. 1994).

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operating liabilities.⁵⁵ Apart from the bank loan and the bonds, its operating obligations are relatively short term and small in the aggregate when compared to its borrowed money (bank and bond) debt.

The merger of American Instruments and US Gauge proved unexpectedly difficult. The corporate cultures were altogether different. (American Instruments was a staid, old-fashioned business based in St. Louis; US Gauge a high-tech, more laid-back outfit based in Sunnyvale.) In addition, the synergies were harder to realize than expected. US Gauge's and American Instruments' sensors both needed to be redesigned to become fully integrated with each other and this would take time. Moreover, demand in the aerospace industry for instruments (and especially for remote sensors) fell in 2000. American Instruments' revenue declined dramatically. By early 2002, American Instruments was in breach of several financial covenants in its loan agreement with the banks. At this point, American Instruments approached the banks to ask for a waiver of the covenants.⁵⁶ The banks agreed to waive the covenants (in return for a fee and an increase in interest rate), and at the same time they began to pay more attention to the loan.⁵⁷

By the time American Instruments returns several months later to ask for additional waivers, it is having difficulty making the semi-annual interest payments on the bonds. In anticipation of the need to restructure its debt, the company begins to identify its large bondholders to include in the restructuring negotiations. At this point, a number of bondholders are sub-par purchasers, investors who acquired the debt as an investment opportunity after the company's fortunes had already begun to decline (at a time when the debt was trading at a discount to par).⁵⁸ After identifying the large-

⁵⁵ This assumption is somewhat artificial. A company of this type will almost inevitably have other liabilities that, while not large enough to alter the basic dynamics of concern to us, play a significant role nevertheless.

⁵⁶ Even where the senior debt is changing hands, the lenders typically are part of a readily identifiable lender group. This group may consist of several lenders, but sometimes may number 50 or more. In most cases, however, one lender is designated "administrative agent" in the loan documents. The administrative agent, usually the bank that syndicated the original loans, is the conduit for information flow between the company and its lenders. In our case (and in the typical case), the administrative agent is the organizing force among the lenders in any debt restructuring, setting up lender/debtor/advisor communications, as well as spearheading any restructuring negotiations.

⁵⁷ For one view of how creditors such as banks monitor and interact with their debtor inside of bankruptcy and out, see Baird & Rasmussen, *supra* note 4, at 697-99.

⁵⁸ Such sub-par investors include the "troubled debt trading desks" at almost every large financial institution, as well as all varieties of private investment funds and other investors. These investors are highly sophisticated and are exceedingly knowledgeable about

est bondholders, the company requests them to organize an informal bondholder committee to participate in restructuring negotiations. By encouraging the bondholders to organize themselves, American Instruments' board can be confident that any restructuring proposal will have significant support within the bondholder group before formal approval is sought.

As part of the ongoing negotiations, the banks and the committee representing the bondholders are supplied with large amounts of information about American Instruments and its business.⁵⁹ They retain, with American Instruments' agreement and at its expense, legal and financial advisors to help them evaluate the information and alternative restructuring plans.⁶⁰ American Instruments provides the creditor groups and their advisors with direct access to its books and records and to its employees for the purposes of permitting them to evaluate the company and its restructuring proposals. The management, with the assistance of its own financial advisor, accounting firm and turnaround experts, develops a long-range business plan for the business, which includes detailed projected cash flows and estimates of debt capacity.

In the first several months of 2003, the banks and the bondholder committee continue to monitor American Instruments and its business. The board hires a turnaround specialist as its Chief Restructuring Officer. After several months, it "promotes" the chief executive to the status of non-executive Chairman of the Board and makes the turnaround specialist the company's new CEO. As the workout negotiations continue, the new management stabilizes and restructures the operations of American Instruments' core business and prepares to sell its and its non-core businesses. The new management team wins the confidence of the bank and the bondholder committee. Both believe that the company, as restructured, can consistently turn an operating profit (assuming it can restructure its debt obligations).

the restructuring process. Many of these investors plan to hold on to the debt only for a limited period, but, as is increasingly common, a substantial number to take a longer term view and approach their investment the way a private equity investor would. In any event, the holders of these bonds are relatively easy to identify and organize.

⁵⁹ The greatest difficulty for a troubled company seeking to organize a bondholder committee often is the unwillingness of some large holders to participate because to do so they would have to gain access to material non-public information about the company and its restructuring. Such access would preclude continued trading in the company's securities by such holders.

⁶⁰ Paying the expenses of the bondholder committee is simply a device that allows the bondholders as a group to share the expenses of the restructuring among themselves. As the residual claimants, the bondholders as a class ultimately bear the restructuring costs regardless of whether they are reimbursed.

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The remaining hurdle to reorganizing the company is the negotiation over the company's new capital structure. A debt restructuring is still required. The banks and the bondholders try to reach agreement outside of Chapter 11, but this proves unsuccessful.⁶¹ American Instruments is unable to make an interest payment to its bondholders. Once the default becomes known, trade creditors tighten the reins, and American Instruments, running out of liquidity, enters Chapter 11. No plan is in place and the banks and the bondholders (who will dominate the official Chapter 11 creditors committee) must take stock of where things stand. This is not a "free fall" bankruptcy. The operational problems of the business are on their way to being under control, and the banks and the bondholders have substantially similar views about the way the business should be run.

In the absence of a pre-negotiated deal on a capital restructuring, the first question becomes whether the business should be sold. American Instruments finds itself in a situation different from that in Qualitech, U.S. Office Products, Bethlehem Steel, or Budget.⁶² The banks might prefer a sale, but they cannot insist upon one, and the bondholders take the view that a current sale is not in their interest. Even the banks recognize that a buyer will not pay the highest possible price for the business until the problems of the business and of the industry are sorted out.⁶³ The entire aerospace sector of the economy is depressed. Businesses in its sector are selling

⁶¹ In many instances, those in the position of the banks and the bondholder committee will be able to reach agreement on a debt restructuring outside of bankruptcy. Sometimes the restructuring can be implemented entirely outside of Chapter 11, for example through amendments to bank agreements and an exchange offer for the bonds. In other cases, the company uses the Chapter 11 process to put in place a deal that already has the support of the major players. Indeed, a substantial number of large Chapter 11 cases—perhaps 30% or so—are cases in which the investors reach such a deal among themselves before the Chapter 11 petition is even filed. Baird & Rasmussen, *supra* note 4, at 678. The business enters Chapter 11 merely as a clean-up operation in which, among other things, dissenting members of the impaired creditor classes can be bound by the requisite Chapter 11 majorities of their classes while the bankruptcy judge assures that the Bankruptcy Code's requirements for protection of their interests are honored.

A good example is Chiquita. The entity that entered bankruptcy was a holding company and its bankruptcy lasted only 100 days. See Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INSTITUTE L. REV. 69, 77-78 (2004).

⁶² See *supra* notes 40, 42-47, 51 and accompanying text.

⁶³ If the banks believe a current sale will realize less than \$250 million (after costs of sale) and future sale would realize more, they too may prefer to reorganize (as long as they receive a sufficient percentage of the future enterprise value in a reorganization to realize the full value of their claims on a present value basis and compensate them for the additional risk they are assuming by deferring a sale).

for multiples that are near or at their historic lows. Potential strategic buyers face the same problems as American Instruments. They have also lost money and have their own debt and liquidity problems. They cannot easily enter the capital markets and acquire the resources needed to acquire American Instruments.⁶⁴

There are, of course, financial investors who specialize in acquiring distressed businesses such as American Instruments.⁶⁵ However, financial buyers will adjust their bids to take account of the risks they perceive themselves to be running, including the informational disadvantage they have relative to the banks and the bondholder committee. To be sure, in a bankruptcy auction (just as in a non-bankruptcy auction) potential bidders typically are offered full access to factual information they reasonably request about the company and its business, including its assets and liabilities, its historical financial statements, its contracts, its leases, its employees, its licenses, its intellectual property and the like. A (physical or “virtual”) data room is created where the bidder and its advisors have the opportunity to review these materials. The bidder is given the opportunity to meet with current management, and sometimes with current employees. This due diligence can be extraordinarily thorough and the bidder can glean from it the information it requires to formulate its own views about the company’s future business, prospects, opportunities and risks. Nevertheless, the bidder does not have access to the existing management’s own assessments of all of these matters. Nor does it have existing management’s plans for the future in the event no sale is consummated.

By contrast, the banks and the bondholder committee have the perspective nearly on a par with an insider. They have an insider’s knowledge about the ability of the business to successfully bring its next generation of instruments and sensors to market. They know what management thinks it could do with the business if it is not sold. Because of their pivotal position in the restructuring process and the informational advantage they possess, these organized creditor representatives have views of the value of the debtor that may depart from those of the outside world. From the point of view of the banks and the bondholders, third party bids may reflect an undue discount because bidders lack the private information to which the banks and bondholders have been given access. Put most simply, the banks

⁶⁴ See Andrei Shleifer & Robert Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343 (1992).

⁶⁵ Wilbur Ross, the buyer of Bethlehem Steel, is one example. See Nicholas Stein, *Wilbur Ross is a Man of Steel*, FORTUNE, May 26, 2003, at 120.

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and the bondholders face another variation on the standard “lemons” problem.⁶⁶

By comparison to creditors of distressed businesses in an earlier era, creditors today (ranging from banks and other financial institutions to universities, mutual funds and hedge funds) increasingly tend to be professional investors who are often willing to forego a market sale in order to recapitalize the debtor through a stand-alone reorganization.⁶⁷ The more sophisticated the investors and the more promptly they can reach agreement on a plan of reorganization, the less tolerant they will be of imperfections in the market for sale of the business as a going concern.⁶⁸ American Instruments’ banks and the bondholders, sophisticated investors of this type, no longer see a Hobson’s choice between a sale in an illiquid market or a costly reorganization. Instead, they see the choice as one between selling the business to other investors in a developed, but not perfect, market or keeping it themselves in a proceeding that has become cheaper⁶⁹ and easier to control over time.⁷⁰

The rates of return expected by potential buyers may be equally attractive to American Instruments’ banks and the bondholders. Bidders will set their bids based on the rate of return that compensates them for the risks they associate with the uncertain future of American. The banks and the bondholders may think to themselves, based on their knowledge of the

⁶⁶ See George A. Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970). Akerlof suggests that used cars are sold for unusually low prices because sellers have private information about whether the car is a “lemon.” Buyers lower their price accordingly, but then sellers with the best cars decide not to sell. This lowers what buyers are willing to pay still further. In the extreme, a market can unravel completely and sales may cease altogether.

⁶⁷ See Goldschmid, *supra* note 25, at 200-06.

⁶⁸ See Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 416 (1990).

⁶⁹ Lynn M. LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganizations*, 1 J. EMPIRICAL LEGAL STUD. 111, 114 (2004) (explaining that professional fees have fallen 57% since the 1980s).

⁷⁰ Indeed, a common complaint about modern large Chapter 11s is the degree of control senior creditors now seem to enjoy over the process. See generally, e.g., Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, 22 AM. BANKR. INST. J. 12, Sept. 2003 (“We have a new form of chapter 11 emerging in the courts. Having invented the DIP (debtor-in-possession), American lawyers are now creating the SPIP (secured-party-in-possession). More and more chapter 11 cases seem to be no more than vehicles through which secured parties may enjoy their Article 9 rights under the umbrella, and protective shield, of the bankruptcy laws.”).

company, “This bidder probably has a rate-of-return hurdle on the purchase price of 30 percent. But the risks aren’t that large. Why should we let him get away with stealing the business for that price? We can just fix the business, sell it in several years, and earn that return for ourselves.” As long as the banks and the bondholders are confident of their own assessment of the business and their ability to control the reorganization process, they may prefer to own rather than sell. The central problem that remains is negotiation of the allocation between them of the value of the business.

At the outset, the committee of unsecured creditors formed in the Chapter 11 case will examine whether the banks failed to perfect their security interests, failed to include assets in the security agreement, or otherwise opened their priority to attack. If they can point to possible infirmities in the banks’ position, some of them may be able to share in the estate even if the banks are not paid in full.⁷¹ For example, in the Chapter 11 of Sunbeam Corporation, out-of-the-money subordinated debenture holders were able to extract 1.5% of the equity by claiming rights arising out of alleged prepetition financial misdeeds.⁷² In WKI Holding, some bondholders increased their stake of the new equity from 5.1% to 8.35% by threatening to probe transactions between its parent and an affiliate of the parent that was also a secured creditor of the debtor.⁷³ The “departures” from bargained-for priority that appear in such cases are in fact nothing of the sort, but rather reflect the uncertainty (albeit often small) about whether an investor who claims to be senior is in fact entitled to priority.⁷⁴

Let us assume, however, that American Instruments’ banks enjoy a priority position that is watertight, the bankruptcy judge is completely committed to the absolute priority rule, and the junior investors have relatively little ability to extract value by holding up the process. American Instruments is not administratively insolvent. Its reorganization value will comfortably exceed the value of the banks’ secured claims and any administrative expenses

⁷¹ In the case of American, the bondholders have very little gain from this review. Even if there are gaps in the liens, the bondholders have agreed to be contractually subordinated. Vendors and other unsecured creditors, of course, are not subordinated to the banks, and would benefit if gaps in the banks liens were found or if the liens were voidable.

⁷² See *Sunbeam Announces Court's Confirmation of Plan of Reorganization*, PR NEWswire, Nov. 25, 2002.

⁷³ See Soma Biswas, *World Kitchen Reorg Plan OK'd*, DAILY DEAL, Nov. 16, 2002.

⁷⁴ Cases may simultaneously involve disputes over priority and over enterprise value. See, e.g., *In re Exide Technologies*, 303 B.R. 48, 60-61, 66 (Bankr. D. Del. 2003). For the purposes of analysis, these sorts of disputes and their negotiated outcomes should be separately considered.

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associated with its bankruptcy proceedings.⁷⁵ The company can be reorganized and general unsecured creditors can expect some sort of recovery on their claims.

American Instruments is the prototypical case our corporate reorganization laws were designed to address. The interaction between in-the-money classes of different priority is the key to the restructuring process. The negotiations are among a relatively small group of professional investors and their experienced advisors who can be counted upon to cast a cold eye on the business and the likely course of any litigation. The subject of that negotiations is the proper allocation between them of the company's ownership – the equity of the reorganized enterprise, which depends, ultimately, upon the value of the enterprise. If the parties cannot reach a deal, the valuation issue will be decided by the court as it applies the absolute priority rule.

As in litigation generally, the banks and the bondholders can make themselves jointly better off by reaching a deal. If the parties can strike a deal, each can avoid the costs of a judicial valuation. More importantly, American Instruments lives in an industry in which long-term supply contracts are an essential part of the business.⁷⁶ Unless it can convince buyers

⁷⁵ It should not be surprising that the banks find themselves fully secured and the business is still worth saving. The banks design triggers in their debt obligations (due dates of payments and financial covenants) to bring parties to the table before matters deteriorate to a point at which the business lacks a value, on a going-concern basis, that exceeds the amount of its secured debt.

If matters become that bad, the dynamic in the case would be utterly different. The banks would control the cash collateral. The debtor would be unable to find a debtor-in-possession lender because the modern bankruptcy judges are unlikely to give the DIP lender a lien that primed the secured creditor. *See* Baird & Rasmussen, *supra* note 24, at ___ (“[C]ourts are unlikely to grant such orders over vigorous opposition.”). Under these circumstances, the secured lender would be able to keep the debtor on a tight leash and dictate the course of the case. The inability of the debtor to support itself would render the junior creditors relatively powerless. A relatively speedy sale would usually be the outcome.

⁷⁶ The need to leave bankruptcy earlier rather than later may stem from a number of different factors. In the case of Consecro, Inc., the debtor needed to regain its AM Best rating for the insurance businesses to be viable. *See, e.g.,* Dan Ackman, *Consecro Turnaround Runs Aground*, FORBES.COM, Dec. 18, 2002, http://www.forbes.com/2002/12/18/cx_da_1218topnews.html. To do so, the holding companies, which owned the stock of Consecro's insurance subsidiaries, had to emerge quickly from Chapter 11 with a strong balance sheet. For an account of how Consecro's weak balance sheet was compromising the ability of the insurance subsidiaries to compete, both before bankruptcy and while it was in it, see Chris O'Malley, *Insurance Group Faces Challenge*, INDIANAPOLIS STAR, December 18, 2002, at 1A.

that its financial problems are behind it and that it will be around for the long haul, its ability to improve earnings are compromised.

The environment in which the senior and junior creditors find themselves, while typical of many large Chapter 11 reorganizations, is quite foreign to most academic accounts of the absolute priority rule and departures from it. There is no plausible claim that the *ex ante* bargain called for anything other than absolute priority. The negotiations are among professionals. The subordination of the bondholders to the banks was established through contract. Every bondholder knew at the outset the nature and the extent of the banks' priority. We are not dealing with tort victims or workers or any other nonadjusting creditors. The managers are newly hired turnaround specialists, not an entrepreneur whose firm-specific skills are essential to the business nor a well-entrenched owner-manager who exclusively possesses valuable private information. Those in charge—the turnaround specialists—want to move the case forward. Their incentives are aligned with the creditors, not the shareholders. Private information plays no role in the bargaining; the banks and the bondholder committee may have different beliefs about the value of the business and the way the bankruptcy judge will assess that value, but neither group has information denied to the other. The bondholders' ability to extract value through delaying tactics is muted. There is no fuzziness about the banks' priority position, nor is there doubt about the commitment of the bankruptcy judge to respecting the bargain between the banks and the bondholders.

In this environment, the banks and the bondholders are likely to behave in a very predictable way. They are likely to agree on a consensual plan of reorganization in which the bondholders end up with junior securities in the reorganized business, the value of which depends heavily on the future performance of the business. In the next part of the paper, we explore the bargaining dynamics at work and suggest why the outcome between the banks and the bondholders takes this form.

III. Bargaining Over Reorganization Allocations in the Face of Valuation Uncertainty

Many accounts of bargaining in Chapter 11 assume it possesses a dynamic peculiar to businesses in financial distress. However, bargaining in Chapter 11 is no different from any other negotiation that takes place in the shadow of litigation. The dynamics at work are captured by the standard settlement model, in which parties to the negotiations have different beliefs

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about the likely outcome of the litigation.⁷⁷ This model can be applied to our American Instruments hypothetical.

Bargaining between American Instruments' banks and bondholders turns on the parties' views of how the bankruptcy judge will value the business. There are at least three sources of valuation uncertainty, all of which will be considered by the court. First, much is unknown about the prospects for the economy generally and the market for the types of goods that American Instruments produces. Second, much is unknown about American Instruments itself, including the strength of its new management team and the quality of the next generation of its product line. Third, much is unknown about the future cost of risk-free capital, which affects the rate at which the market will discount American Instruments' future earnings potential in evaluating its value as a business enterprise. As to each of these uncertainties, the banks and the bondholders may have different beliefs, but neither has an informational advantage over the other and both know as much or more than any outsider.

These uncertainties exist in every case, but the need to use markets to monetize the value of the business is reduced where the parties have the expertise to weigh the risks and come to their own educated view regarding the value of the enterprise. The experienced professional investors who today tend to displace passive investors as financial distress approaches are likely to have this expertise. They are as well qualified to restructure and maximize the return on the business at this moment in its life cycle as any financial bidder who might purchase the business.⁷⁸ The value of the business in their hands is likely to be as high as it would be in the hands of the purchaser. Together with their advisors, they are well qualified to assess that value for purposes of negotiating how such value should be allocated under a plan of reorganization.

When the parties to the reorganization negotiations, like American Instruments' banks and the bondholders, can form a sophisticated view on the value of the enterprise, they can resolve the valuation issue through their own action. One can conceive of a mechanism that would force the

⁷⁷ See generally William M. Landes, *An Economic Analysis of the Courts*, 14 J. L. & ECON. 61 (1971). Alternative models of settlement are based on bargaining in the face of private information. See, e.g., Lucian Arye Bebchuk, *Litigation and Settlement under Imperfect Information*, 15 RAND J. ECON. 404, 408-09 (1984). As between the banks and the bondholders, however, there is no private information.

⁷⁸ In some cases, the business will be more valuable to a strategic investor than to a financial investor. In such circumstances, the business is more likely to be sold. In the American Instruments hypothetical, it is assumed that strategic buyers are not in a position to be competitive bidders.

junior investor to buy out the senior investor to preserve the value the junior investor's interest in the business. It would effectively require the junior investor to “put up or shut up” based on the junior investor's own views of the value of the business. Based on her view of the value of the business, the junior investor would decide whether, as a risk-reward proposition, she has enough confidence that the value of the enterprise will exceed the senior investor's claims to buy out the senior investors' position. Alternatively, one could provide for an allocation of ownership of the enterprise based on a judicial appraisal, but allow the parties to avoid this allocation by agreeing to an allocation amongst themselves. The latter approach—the one adopted in Chapter 11—avoids the need for consideration to change hands between the parties. In the absence of a settlement, it “divides the baby” based on the judge's determination of value, which may depart from what either the senior investor or the junior investor think the business is worth.

Let us examine these two alternative reorganization procedures—forced sale and judicial appraisal—more closely.

The “Forced Sale” Model

Situations in which the owners of a business need to reallocate ownership interests among themselves are commonplace. Two parties to a joint venture decide to go their separate ways. Two partners no longer want to work with each other and one must buy the other out. In such situations, parties often agree in advance to a dissolution mechanism that puts a value on the business and allows one party to buy the other out. A standard mechanism is “the Texas shoot-out.”⁷⁹ One of the parties sets out a dollar figure and the other must buy out the first party's interest or sell her own for that price. When neither party faces any liquidity constraints, this mechanism forces the party who makes the offer to reveal the value she places on the business. For this reason, this mechanism has a distinct advantage over use of a third-party appraiser. It takes advantage of the private information the parties have, but cannot credibly convey to a third party.

Alternatively, the two parties may agree on using a third party to put a value on the venture when it is terminated. For example, the contract may give one of the parties the right to to sell its interest in the venture to the other partner for the price the appraiser sets.⁸⁰ This “put” mechanism is

⁷⁹ See generally Richard R.W. Brooks & Kathryn E. Spier, *Trigger Happy or Gun Shy? Dissolving Common-Value Partnerships with Texas Shootouts* (Yale Law & Economics Research Paper No. 298, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=556164.

⁸⁰ For examples of such contracts, see Keith Scharfman, *Valuation Averaging: New Procedure for Resolving Valuation Disputes*, 88 MINN. L. REV. 357, 364-65 (2003) (describing con-

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particularly useful when the partner who wants to terminate the venture does not have the liquidity to buy the other out, a *sine qua non* of the dissolution mechanism that uses the I-pick-you-choose principle.

Both of these mechanisms invoke a “forced sale” to resolve the value allocation issue. The “Texas Shoot Out” lets the parties set the price; the appraisal method leaves the valuation to a third party. Importantly, both of these mechanisms by-pass any need for negotiation between the parties.

A law of corporate reorganizations also could insist upon a market mechanism or one that took advantage of the private information the parties possess by forcing one to buy the other out. Indeed, as others have observed, the hierarchical nature of the parties’ interests in the distressed debtor makes such mechanisms, in theory at least, easy to implement. The reorganization procedure would be comparatively simple. It would permit the junior investor to buy out the senior investor for the amount of the senior investor’s claim.⁸¹ There are any number of variations on such a mechanism. They all take advantage of the private information the junior investor is presumed to possess. As long as the junior investor faces no liquidity constraints and in fact has sufficient information to perform an educated evaluation, she will buy out the senior investor if, but only if, the business is, in the junior investor’s view, worth more than the senior investor is owed. The senior investor cannot complain if she is paid in full, and the willingness of the junior investor to buy out the senior investor reveals that, in her own eyes, her ownership interest in the business is not out-of-the-money.

Whether such a mechanism is one parties would bargain for in advance, however, is not clear. It relies critically on the ability of the junior investor to accurately assess the value of the business and to muster the capital to buy out the senior investor’s position. Because of the private information the existing investors possess and because a prudent lender, even with full information, will lend against an asset only a fraction of the value of the business (determined without the benefit of private information), the junior investor typically cannot borrow against the business from a third-party lender funds sufficient to pay off the senior investor. Moreover, the additional investment that the junior investor must make under this mechanism is difficult to diversify against. This is especially true where the “junior investor” is in reality a large group of disparate investors (e.g., bondholders)

tractual valuation mechanisms using expert appraisers in Merck/Schering-Plough and Verizon/Vodafone joint ventures).

⁸¹ See Bebchuk, *supra* note 34, at 781-88. Even apart from liquidity problems, this mechanism can work effectively only if the priority positions of all the investors is clear. In many cases it is not.

who may not be in communication with each other and not all of whom, in any event have access to private information. In the case of American Instruments, for example, the bondholders would collectively have to put \$250 million at risk, something they might not be willing or able to do as a concerted group even if the largest holders, with the benefit of private information, believed that, in expectation, the business was worth more than \$250 million.⁸²

Recognizing the practical difficulties in the corporate reorganization context of imposing on junior investors a forced sale that takes advantage of private information, we next turn to the alternative model actually adopted by our reorganization laws – the “judicial appraisal” model of corporate reorganization.

The Judicial Appraisal Model

Modern Chapter 11 is the equivalent of a provision in a joint venture agreement that calls for the appointment of an appraiser and uses the number that the appraiser sets (or is expected to set) as the baseline against which to measure the rights of the parties. In the abstract, one cannot say whether such a regime makes sense. We see sophisticated parties adopt such mechanisms in analogous environments.⁸³ Nevertheless, adopting such a mechanism, like any other valuation mechanism, has predictable consequences. In particular, any valuation mechanism that does not involve a transaction that monetizes the senior investors’ position (through a sale of the business or a buy-out of the position) creates option value in the position of the junior investors. This will be priced into any deal the parties strike with each other that avoids the need to complete the valuation.

We can understand the bargaining dynamic between the banks and the bondholders in American Instruments by imagining an even simpler example. Firm is a debtor in Chapter 11. Its only asset is an oil well. The only source of uncertainty is over the amount of oil beneath the ground. It has two creditors, Bank and Lender. Bank has lent \$250 and Lender \$200. Bank has a security interest in all of Firm’s assets. Bank and Lender each know as much about the amount of oil in the ground as the other. They have read the same geologist reports. They know Firm’s own experience and its man-

⁸² Today, even in the absence of a bankruptcy law requirement, junior investors could offer to buy out senior investors as a group, especially, as is commonly the case, where all of the senior investors are party to a single syndicated bank credit agreement. Typically, however, while senior claims trades and junior investors are sometimes buyers, such transactions are trades between individual holders, normally at a discount to par.

⁸³ See Scharfman, *supra* note 80, at 364-65.

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agers' intuitions about how much oil is there. They can convey much of what they know to an outsider, but not everything.

We can imagine a number of different variations on this hypothetical. Let us assume first that Bank and Lender share the same beliefs about the amount of oil in the ground. They both believe it is worth \$250. No outside buyer, however, will pay that much for the oil well. The outside buyer will bid less, as it must discount for the possibility that Bank and Lender are selling the oil well because their private information tells them the well is worth less than it seems.

Bank and Lender believe that the average estimate of 100 fully informed appraisers would be the same as their own, but they recognize that any individual appraiser might be higher or lower. The standard deviation is 10%. Bank and Lender also believe that a bankruptcy judge who listens to expert witnesses is in the same position as an unbiased appraiser. Over the course of a 100 cases, her median valuation, like the appraisers', will be \$250, but there is again a standard deviation of 10%. The bankruptcy regime allows Lender to insist on a valuation hearing and the valuation hearing costs Lender and Bank \$2.50 each. What happens when Bank and Lender negotiate in the shadow of a valuation hearing in this environment?

Lender's ability to insist on a valuation hearing is an option that has value. The bankruptcy judge is, by assumption, an unbiased appraiser whose expertise is as good as that of any third party expert. Nevertheless, the bankruptcy judge does not know the amount of oil in the well with certainty and this uncertainty is itself a source of value to Lender. To be sure, when the bankruptcy judge finds that the business is worth less than \$250 (which she will do half the time), Lender receives nothing. But in the remaining cases, the bankruptcy judge will find that the business is worth more than \$250. In these cases, Lender will receive the difference between the value the bankruptcy judge applies to the business and \$250. With a standard deviation of 10%, the "cram up" option that Lender enjoys is worth \$10.⁸⁴

The right to demand a valuation hearing before an impartial bankruptcy judge, like the right to demand an independent third-party appraisal, comes with subtle distributional effects. Seen after the fact, the junior investor is better off and the senior investor is correspondingly worse off than they

⁸⁴ The expected value the bankruptcy judge will place on the company is equal to the value of Bank's \$250 claim. Lender accordingly has an expected gain in the event of litigation because it can never get less than nothing and half the time it will get more. Bank has an expected loss in the event of litigation for the same reason Lender has an expected gain. Bank can never receive more than the entire company after a valuation and half the time it will get something less.

would be in the counterfactual world in which the property was sold for the amount both Bank and Lender believe it is worth. The junior investor is also better off than she would be in a world in which she faced no liquidity constraints, but was obliged to buy out the senior investor's claim in order to continue her interest in the business. If she were required to buy out the senior investor at par, she might realize the upside, but could also lose a portion of her investment in the senior claims if the business turned out to be worth less than expected. If, instead, she can impose a value allocation based on a judicial appraisal, she benefits from the upside but has no additional investment at risk on the downside.⁸⁵

The Impact of "Appraisal Variance"

The parties to the reorganization negotiations will each have their own view of the value of the enterprise. Their respective valuations – which may, as in our example, be the same, or may be different – are based on their respective assessments of a number of variables, such as their expectations regarding the range and probability of different real world outcomes for the business, and their subjective views regarding valuation methodology, discount rates, and the like. An appraiser may share one or the other of the parties' views regarding these subjects, or may have different views.⁸⁶ Each party accordingly faces the possibility that the appraised value of the enterprise will depart from the party's own valuation, and the party's expectations regarding the probability and the potential magnitude of such a departure directly impacts the party's negotiating strategy. We call the risk of such departures, "appraisal variance."

To illustrate the impact appraisal variance has on reorganization negotiations, compare a regime involving the option of a judicial appraisal with one in which both Bank and Lender must wait until the oil has been extracted from the ground and the amount of oil in the well is fixed with certainty. Whether the opportunity to force an appraisal has an impact on ne-

⁸⁵ Exercising the junior investor's "option" may not, however, be cost free if the junior investor's has to bear the cost of litigating the valuation issue. If a creditors' committee prosecutes the valuation litigation on behalf of the junior investor, the junior investor will be relieved the costs of litigation (which would be borne by the debtor, and, therefore, indirectly by the senior investor). *See infra* note 92.

⁸⁶ In practice, bankruptcy judges may exhibit greater appraisal variance than randomly selected experts. Variance decreases with greater information and the adversarial process itself limits the ability of the judge to gather information. The bankruptcy judge bases her appraisal on conflicting testimony from experts who themselves may be biased. They are advocates for a particular valuation perspective that serves the objectives of the litigants who selected them, and will tend for that reason to represent more extreme ends of the range of credible opinion.

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gotiating incentives depends on whether there is a difference between the parties' expectations regarding appraisal variance on the one hand and the parties' expectations regarding the variance of real world outcomes on the other. In a simple case, it might be that Bank and Lender both believe that the expected quantity of oil is worth \$250, but also believe that, just as with respect to appraisals, there is a standard deviation in the real world outcomes of 10%.⁸⁷ Under these circumstances, the bargain that Bank and Lender strike in the appraisal regime should be comparable, in terms of distributional consequences, to a regime that simply obliged the parties to wait. Bank and Lender could, for example, agree upon a new capital structure in which Bank receives 100% of the equity and Lender has the option in two year's time to buy Bank's equity for \$250 plus a risk-adjusted market rate of return.⁸⁸ Even if Lender faces liquidity constraints now, these will disappear when the oil is extracted and its quantity is known. Bank will receive its entire \$250 plus compensation for delay before Lender receives anything. The deal preserves the option value associated with Lender's junior position in the same way an appraisal would in the event the oil turns out to be worth more than \$250. Because the expected variance associated with the appraisal is the same as the expected variance associated with the real world outcome, the ability to insist on an appraisal should not affect the negotiating positions of the parties.

There is no guarantee, however, that the parties' expectations regarding the variance associated with an appraisal will match the parties' expectations regarding the variance in real world outcomes. First, imagine a situation in which there is no appraisal variance despite a wide variance in real world outcomes. A business whose only asset is a lottery ticket that has a one in ten chance of paying \$2500. Bank is again owed \$250. There is no ambiguity about the expected value of the ticket, nor any doubt that all third-party appraisers would fix on it a value of \$250. The outcome where Lender has a right to insist on a third-party valuation is no different from the outcome if Lender were obliged to buy out Bank's position or the lottery ticket were sold in the market place. Lender would receive nothing under any of these scenarios. Lender's claim could, however, have value if Lender can force a delay. Where the appraisal variance is small compared to the parties' expec-

⁸⁷ The variables that make it hard to predict the expected result of a third-party appraisal also make it hard to predict the actual output of the well. For our purposes, however, what matters is that Bank and Lender have less valuation variance than anyone else by virtue of their access to private information.

⁸⁸ Because Bank is taking equity risk – the oil extracted turns out to be worth less than \$250, it would bargain for a “blended” return reflecting this risk before Lender could participate in recoveries.

tations regarding real world outcomes for the business, the senior investor should favor an immediate day of reckoning that collapses future values to the present, even if the mechanism for implementing the day of reckoning is an appraisal. The junior investor should favor delay.

But once we recognize appraisal variance, it is no longer the case that junior investors necessarily favor delay. Consider the case in which the expected appraisal variance is greater than Bank and Lender's own uncertainty about the actual value of the business. To the extent, for example, Bank and Lender are better informed about the amount of oil in the well, the variance among the appraisals may be greater than their own expectations about the variance in the amount of oil in the ground. In such situations, Lender's ability to insist on an immediate appraisal has value. If the appraisal variance is large compared to the senior investor's own expectations regarding the variance in real world outcomes for the business, the senior investor should favor delaying an appraisal until the real world outcomes are better known.⁸⁹

If the senior investor can force a speedy day of reckoning, the senior investor should be inclined to do so where there is little appraisal variance. The senior investor can insist upon a prompt valuation and request that the junior investor be "crammed down." When the outcome of the valuation process carries greater uncertainty, it is the junior investor who has the incentive to seek an appraisal of the enterprise today. Where the appraisal variance is large, the threat of "cram-up" is a potent one, well understood in practice, but wholly neglected in theory.

In sum, uncertainty over the outcome of a valuation generates option value. When there is sufficient uncertainty over the outcome of an unbiased valuation, the ability of the junior investor to force a valuation has value even when there is no disagreement between the parties about the uncertainties associated with the appraisal and the appraisal is completely unbiased. A rational senior investor will take into account the value of the junior investor's option (or, more specifically, the threat that it will be exercised by voting against the reorganization plan) in making any settlement offer. A senior investor's willingness to "buy" this option from the junior investor will naturally lead to plans of reorganization in which the junior investor

⁸⁹ It should be noted, however, that the senior investor will tolerate greater appraisal variance if the expected value of the enterprise is sufficiently low. Where the expected value is sufficiently low, appraisals at the high end of the range of variance still may not cover the senior investor's claim. In such cases, the senior investor should favor a speedy appraisal even where the appraisal variance exceeds her expectations regarding the variance of real world outcomes. The dynamic at work here is related to, but ultimately distinct from the similar dynamic Adler identifies in bargaining between senior and junior lenders. See Adler, *supra* note 19, at 226–29.

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participates, even though, by the terms of the contractual bargain separated from the valuation problem, the junior investor should not participate based on the expected value both parties place on the business.⁹⁰

If the senior investor and the junior investor share the same view of the business's prospects and the way in which the bankruptcy judge will assess them, a settlement range exists that makes both the senior investor and the junior investor better off. They are likely to reach an agreement in which the junior investor is paid the value of its option to insist upon a valuation and the parties allocate between them the savings they would realize from bypassing the valuation process. These would include the direct costs of the process itself and the indirect costs of delaying the business's emergence from bankruptcy.⁹¹

Negotiating in the Face of Appraisal Variance: Postponing the Day of Reckoning

If appraisal variance is expected to be large, the key question in plan of reorganization negotiations between Bank and Lender is how to allocate reorganization distributions in a way that accounts for the value of Lender's cram-up option (the ability to impose on the senior investor the risk that the bankruptcy judge will settle on a value for the business that is at the high end of the range of variance). As suggested above, this is so even where Bank and Lender share the same view about the expected outcome and the likely variance of the judicial appraisal.

The parties may, however, find it difficult to agree on the value of Lender's option. If they do, there is another alternative they can explore. They can agree to postpone the day of reckoning by preserving Lender's option until a later date, by which time it is hoped the value of the enter-

⁹⁰ The observation we make here—that an ex ante agreement for absolute priority will in fact yield something less than absolute priority ex post—raises a second set of questions. The efficient investment contract in fact might be one that provides for absolute priority ex post. See Schwartz, *supra* note 3, at 1812-13. If this is so, we should ask whether devices are available to investors to allow ex ante contracting that would in fact yield absolute priority. To frame things differently, is there a way to write an ex ante absolute priority contract that is renegotiation proof? What is the evidence that parties are trying to write such contracts (for example through the creation of bankruptcy remote single purpose financing vehicles)? If our reorganization system precludes such contracts from being written, or makes their enforcement more difficult, is the cost this imposes for the sake of preserving the opportunity to reorganize sufficiently counterbalanced by benefits derived from preserving this opportunity? These lines of inquiry and others like it are the ones that should be pursued, rather than ever more elaborate models that seek to explain apparent departures from absolute priority on the basis of private information and firm-specific human capital.

⁹¹ See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 607-10 (5th ed. 1998).

prise can be more readily established in the market. While this type of solution raises some tricky governance issues (specifically, control of the business during the period of postponement), postponing the day of reckoning permits Bank and Lender to save the cost of the valuation while preserving their relative rights. An example of such a solution would be for Bank and Lender to agree to a plan that allows Lender to buy out Bank's interest several years hence, providing Bank with an appropriate rate of return in the interim. Another possibility would be to design a distribution allocation procedure with a built-in adjustment mechanism that locks in the final allocation of investor participation only after the market has reliably established the value of the enterprise.

The usefulness of postponing the day of reckoning can be seen if we complicate our example by assuming that the appraisal process not only exhibits substantial variance, but also that Bank and Lender have different beliefs about the likely outcome or variance associated with the appraisal. This will make it more difficult or perhaps even impossible for the parties to agree upon the value of the junior investor's option. However, as we shall see, if the parties agree to postpone the day of reckoning, there may be negotiated solutions that will satisfy both parties.

Assume that Bank believes the judge will share its own view of Firm's value and find that, in two year's time, Firm will be worth either \$225 with 80% probability or \$375 with 20% probability. Collapsing these possibilities yields an expected valuation of \$255. By contrast, Lender believes that the judge will share its view that, in two year's time, Firm will be worth \$225 with 20% probability or \$375 with 80% probability. This results in an expected value of \$345. A valuation hearing costs Bank \$20 and Lender \$15.⁹² Under these assumptions, Lender expects to receive \$80 if it contests valuation.⁹³ Bank, however, will spend no more than \$25 to settle with Lender.

⁹² The assumption that Lender will bear fewer of the costs of the valuation hearing is plausible. See Arturo Bris et al., *The Costs of Bankruptcy: Chapter 7 Cash Auctions vs. Chapter 11 Bargaining* 7-8 (Yale ICF Working Paper No. 04-13, 2004), available at <http://www.nber.org/confer/2004/si2004/cf/bris.pdf>. If the official creditors' committee carries the burden of the valuation proceeding and if the plan ultimately provides the junior creditors with contingent rights of participation, part of the cost of the process will shift from the junior creditors to the senior creditors. (In states of the world in which junior creditors have options that turn out to be out of the money, the costs of the bankruptcy borne by the debtor are borne entirely by the senior creditor.) Of course, if all payouts are in cash at the end of the case, then the junior creditors bear the cost as long as the debtor is not administratively insolvent.

⁹³ The bankruptcy judge will find that Firm is worth \$345 and will give Lender a share in the reorganized firm that is worth \$95. Less the \$15 cost of the litigation, Lender realizes \$80.

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Bank believes Firm is worth only \$255 and it expects to receive \$230 after a valuation hearing.⁹⁴ From its perspective, a settlement with Lender (acquiring Lender's interest in the firm) can benefit it only to the extent of the difference between the two. No cash settlement will make both parties better off than they expect to be after the valuation hearing.

Bank and Lender will look for alternatives to a cash settlement. In a world in which Lender faced no liquidity constraints, Lender would buy Bank out. Lender believes Firm is worth \$345 and its own stake is worth \$95. Hence, it would pay up to \$250 to acquire outright ownership. By contrast, Bank believes that a valuation process will bring it only \$230. Hence, a bargain exists in which Lender and Bank are both better off. If those in Lender's position generally faced no liquidity constraints, the law of corporate reorganizations could simply provide that Bank succeeds to the entire Firm unless Lender is willing to pay it the face amount of its loan.⁹⁵ As we have noted, however, Lender is likely to be subject to liquidity constraints.⁹⁶ Bank and Lender find themselves facing a bankruptcy court valuation only because Firm is not readily marketable. Lender and Bank value Firm more than outsiders do. They have private information that prospective buyers do not. The conditions that give rise to the situation in which Bank and Lender find themselves are inconsistent with Lender having the ability to raise the capital needed to buy out Bank's position.

Bank and Lender can, however, still find common ground. They can look to a mechanism that defers the final allocation of their ownership participation in the reorganized enterprise until the value of the enterprise is better known. Consider, for example, a settlement in which Firm acquires an all-equity capital structure. Bank receives all the equity in Firm, but Lender enjoys the right to buy the equity of Firm from it in two years time for \$275. Bank and Lender do as well with such a bargain as they would by going through a valuation process. This plan gives Bank an expected return of \$235, \$5 more than it would receive in a valuation hearing.⁹⁷ The plan

⁹⁴ Bank believes that the bankruptcy judge will agree with its valuation and hold that Firm is worth \$255. Because Bank is owed \$250, the judge will give it virtually the entire reorganized firm. After spending \$20 on the valuation hearing, it is left with \$230.

⁹⁵ Lucian Bebchuk was the first to make this point. *See* Bebchuk, *supra* note 34, at 781-88.

⁹⁶ Even apart from the issues raised here, the bondholders who occupy Lender's position in a case such as *American Instruments* are dispersed. Working in concert becomes even harder if they must make capital contributions.

⁹⁷ Bank believes that Firm will be worth \$225 in eight cases in ten. When Firm finds itself in such circumstances, Lender will not exercise the option, and Bank will remain the

gives Lender an expected return of \$80, an amount equal to what it expects to receive in a valuation procedure.⁹⁸ The liquidity problem that Lender faces today will not exist in two years, as by then the market for Firm's securities will have established itself and Lender will be able to borrow the money needed to exercise the option or it will be able to sell the option to someone else.

In the case described above, both Bank and Lender believe the expected value of Firm exceeds the amount Bank is owed. They merely disagree about the size of the expected surplus. Even if, however, Bank believed the expected value of Firm were not sufficient to pay it in full, it might nonetheless believe the valuation variance is sufficiently large so that Lender could be in the money if the judge's valuation were at the high end of the valuation range. Under such circumstances, Bank would still have an incentive to offer Lender some continuing rights against Firm to reflect the value of the option implicit in the right to insist on a valuation. Especially in such circumstances, Bank may find it far easier to offer Lender some form of contingent rights that defer Lender's final day of reckoning than it would be to offer Lender a cash settlement or some other finite participation interest in the ongoing firm.

The possible features of such contingent rights and the flexibility parties have to tailor them to the value (or lack of value) implicit in the junior investor's position is the topic to which we now turn.

IV. The Use of Options to Settle Valuation Issues in Reorganization Cases

So far we have suggested that, to a far greater extent than commonly appreciated, bargained-for departures from absolute priority are motivated by valuation uncertainty. We have also suggested that, while negotiations in large reorganizations are fact-dense and plans of reorganization are complicated, the bargaining dynamics are similar from one case to the next. These dynamics regularly lead to negotiated plans of reorganization with basic features consistent with the idea that valuation uncertainty dictates the contours of such plans. These observations, together with the illustrations above, suggest there should be some discernable patterns to how valuation uncertainty is addressed in reorganization settlements.

sole owner of Firm. One time in five, Firm will be worth \$375. In these cases, Lender will exercise its option and Bank will receive \$275. Hence, the expected value of Bank's share under the plan is worth $(0.8 * 225) + (0.2 * 275) = 235$.

⁹⁸ When Firm proves to be worth \$375, the right to buy it for \$275 is worth \$100, and Lender believes this event will happen 80% of the time.

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Settlements of valuation issues in large Chapter 11 cases take many forms. Often such settlements do not involve giving the junior creditors options that turn on the future value of the business. It is far simpler to allocate a fixed percentage of the common stock of the reorganized debtor to the junior class in recognition of the option value inherent in the junior class's ability to force an appraisal of the enterprise. The amount of equity allocated to the junior class in such circumstances includes an "option value" component⁹⁹—a component on account of the possibility that the court might adopt a higher-than-expected valuation if the issue were litigated. The size of this component, or whether it is offered in settlement at all, will of course depend upon whether or not the senior class views there to be a realistic risk of the higher valuation being adopted by the court.

Senior and junior investors may, however, find it difficult to arrive at a mutually satisfactory split of the reorganized debtor's common stock, especially when the senior and junior investors have divergent beliefs about the underlying value of the business or the value the judge will place on it. Settlements involving an outright division of the reorganized debtor's common stock cannot navigate around the central difficulty of applying the absolute priority rule. Fixing the allocation of common stock between the senior and junior classes in the plan of reorganization makes the plan confirmation date a "day of reckoning" in the sense that the finality of the allocation extinguishes (or more precisely circumscribes) the option value of the junior class's position. As we suggest above, in these circumstances it may well be easier to reach agreement if the day of reckoning can be postponed for a time through designing a distribution mechanism that to some extent perpetuates the optionality in the junior investor's position. Securities can be designed with option features that allow time after the effective date of the plan of reorganization for the market to determine the value of the enterprise and the allocation of ultimate ownership rights in the business.

The reorganization plan might, for example, initially allocate virtually all of the common stock of the enterprise to the senior class based on a conservative valuation. It could then preserve for a time the right of the junior class to purchase some or all of the common stock, either directly from the senior class or, more typically, from the reorganized company. The price to be paid for the stock by the junior investor could be set by reference to an enterprise value sufficient to provide the senior investors a full recovery

⁹⁹ The reference to an option value "component" is in recognition of the fact that the junior class may be entitled to some value even at the low end of the valuation range. The option value component is only that portion of the distributions that related to the possibility that the judicial valuation could be higher than expected.

plus an appropriate risk adjusted return. A plan with this feature might offer the junior class only a limited period of time to elect to purchase (for example, pursuant to a “rights offering”) or might offer a readily marketable security, such as a warrant, that has a longer term.¹⁰⁰ Settlements of this type can be structured in many ways, subject to the ability of the capital markets to accommodate the new securities. As long as the rights or warrants are freely assignable and a market for them eventually comes into being, these contingent rights do not force the junior investors to contribute new capital to realize the value of their rights.¹⁰¹

There are also alternatives that avoid the need for the junior class to supply new capital. For example, a plan can allocate the majority of the common stock to the junior class while the senior class retains a senior se-

¹⁰⁰ The shorter the amount of time in which the junior creditors have the ability to exercise these options, the more they become like Bebchuk options, which are rights that the junior investors have to buy out at senior investors at the time of the reorganization. *See supra* note 95 and accompanying text.

¹⁰¹ The junior investors are better off being able to bargain for an ongoing option than they would be if they were required to buy out the senior investors to preserve the option value of their position. The appraisal model thus affords two distinct benefits to junior investors over the forced sale model. First, it provides junior investors with the ability to threaten an appraisal that potentially has greater valuation variance than the variance associated with real world outcomes (thereby increasing the option value of the junior investors’ position). Second, it permits junior investors to bargain to preserve the option value of their position without the need to put new capital at risk.

The incremental option value associated with judicial appraisal stems not only from the potentially greater variance associated with expert appraisal than with real world outcomes, but also from the likelihood that the variance associated with an appraisal by a judge who is not a financial expert and who is hearing testimony from experts hand-picked as advocates by opposing litigants will be greater than the variance associated with an appraisal from an unbiased experts. This potential for increased variance is not associated with judicial bias, but rather with the judge’s lack of expertise and the likelihood that the testimony will exhibit systematic bias associated with the advocacy process both on the high side and on the low side. Critics of deviations from absolute priority can legitimately ask whether, apart even without manipulation of the process or bias on the part of the judge, it is appropriate for the system to afford to junior investors the value associated with this incremental appraisal variance. It is a cost our system imposes on senior investors as the price of permitting them the opportunity to reorganize rather than sell, and the question is whether providing this opportunity is worth the cost. Assuming it is worth this cost, the next question is whether there are reforms that could help to minimize that cost.

The combined effect of the ability to bargain for an ongoing option without being required to put further capital at risk and the incremental option value associated with the potentially greater variance of a judicial appraisal suggests that there is in the current system a certain amount of leakage of value to junior investors that could be criticized as a genuine departure from absolute priority.

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curity convertible into common stock. The senior investors can convert the security into common stock commencing at some future date if the market demonstrates that the senior investors are the true owners of the enterprise. In at least two recent cases (those of LaRoche Industries in 2001 and Consecoco in 2003), such a “relative priority” security was issued to the senior investors, taking in each case the form of convertible preferred stock.¹⁰² The preferred stock included a delayed conversion feature that permitted the debtor the opportunity to redeem the security before the date on which the conversion feature could be exercised.¹⁰³ If the debtor could not accomplish the redemption, the conversion feature would become exercisable and the senior investors could effectuate a change of control of the company.

A convertible preferred stock of this type has a number of attractive features. By converting senior debt to preferred stock, it reduces the debtor’s indebtedness to a sustainable level. The delayed conversion feature coupled with the redemption feature gives the new shareholders (the junior investors) time for the market to demonstrate that their asserted higher valuation can in fact be realized. If the higher values are attained, the security can be redeemed and the junior class can retain their controlling stake in the common stock. From the perspective of the senior class, the security sets a deadline for the transfer of control to the senior class while preserving their senior position. An adequate dividend rate on the security, which can be “paid in kind” until the conversion date, can assure that if the security is redeemed, the senior class is in fact paid in full.¹⁰⁴ If properly designed, the security can be marketable, permitting those senior investors who desire to exit before the conversion date to do so.¹⁰⁵

Return to the American Instruments hypothetical. The plan of reorganization might take the following form. Both the banks and the bond-

¹⁰² Consecoco, Inc., *supra* note 5, at 149; In re LaRoche Industries, Inc., *Debtors’ Second Amended Joint Plan of Reorganization*, Cases No. 00-1859 (D. Del. Bankr., Mar. 29, 2001) [hereinafter Laroche, Debtors’ Second Amended Joint Plan], at 10-11.

¹⁰³ Laroche, Debtors’ Second Amended Joint Plan, *supra* note 102, at Exhibit C.

¹⁰⁴ In Consecoco, for example, this dividend rate was 11% and was paid in kind until redemption or the conversion date, after which the coupon was payable in cash. *Second Amended Disclosure Statement*, *supra* note 6, at 35.

¹⁰⁵ In Consecoco, price quotes were available for Consecoco’s new convertible preferred stock shortly after it emerged from Chapter 11 on September 10, 2003, and the stock could be sold at close to its par value. *Consecoco, Inc. Emerges From Chapter 11*, INSURANCE NEWS-CAST, Sept. 12, 2003, available at www.worksite.net/091203earn.htm#1; Daily Adjusted Prices for Consecoco Inc. 12/15/03 to 12/31/03 & 1/15/04 to 1/30/04, DialogClassic Web, available at www.dialogclassic.com/COMMAND.HTML.

holders agree that the business that emerges from Chapter 11 should carry only \$100 million in debt and that the banks will take all of it. The question becomes one of dividing the equity. The banks believe that the business is worth no more than \$250 million and that they are therefore entitled to virtually all of the equity of the reorganized business. The bondholders believe that the value of the business is significantly higher—as much as \$375 million—and that they are entitled to a majority of the equity of the reorganized business.

A conventional settlement is not possible because of the disparity in the parties' views of the value of the enterprise (and the likely outcome of any litigation over valuation) and the inability of the bondholders at the time of the reorganization to borrow enough to buy out the banks' position. The parties can, however, find it in their mutual interest to agree on a plan of reorganization that puts off the day of reckoning. Putting off the day of reckoning expands the settlement range. The crucial feature of such a settlement resides in the nature of the security the bondholders receive (rights that have value only if American Instruments proves to be worth more than \$250 million). These rights are something that the bondholders value highly, given their belief that the business is worth substantially more than \$250 million), and that the banks value hardly at all, given their belief that the business will prove not to be worth much more than \$250 million.

Under one such plan, virtually all of the common stock is issued to the bondholders. The banks receive two different securities. First, the banks receive new bank debt in the amount of \$100 million. For the balance of their claim (\$150 million), the banks receive convertible preferred stock with a par value of \$150 million. Dividends accrue over time, but are not paid out. The company has the power to redeem the preferred stock at par plus accrued dividends at any time (at the reorganized company's option). In two year's time, however, the banks have the right to convert their preferred stock. The conversion formula is set in such a fashion to give the banks the ability to acquire most of the equity of the business in the event that the business turns out to be worth less than \$250 million. In the event that the business turns out to be worth more materially more than \$250 million, the company will exercise its right to redeem the preferred stock. Because the robust economic condition of the restructured business will have become apparent by that time, the company should have little trouble raising the funds needed to redeem the stock even though that amount cannot be borrowed today.

This bargain is a departure from absolute priority in that, if the business were sold today, the bondholders might realize little or nothing, while the banks might have been paid in full or nearly in full. For the bargain to be struck, the banks must feel it benefits them enough to offset the risk of having to wait to lock in their ownership of the reorganized company if, as

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they believe, the business in fact proves to be worth less than \$250 million.¹⁰⁶ The settlement eliminates for them the risk of an adverse determination on valuation and the cost of litigation over valuation issue. If the banks are confident that, during the waiting period, the business will at least retain its current value until the contingencies built into the bargain are resolved, they may well conclude it is worth striking the bargain to avoid a show-down over value. This will be especially true if the banks can reduce their risk by monetizing the value of the preferred stock by selling it in the market before the end of the waiting period. Because the reorganized company has only \$100 million of debt, the preferred stock should have substantial market value—perhaps even approaching par.¹⁰⁷

The plan of reorganization that emerges appears to depart from the absolute priority rule. The bondholders receive more than they would in the counterfactual world in which the banks could insist on an immediate day of reckoning by forcing a sale of the enterprise or basing a reorganization plan on a valuation at the median of the valuation range (based, for example, upon the average of multiple independent and unbiased expert appraisals¹⁰⁸).

The world of Chapter 11 is a world in which junior investors enjoy an option that arises whenever the outcome of the valuation process is uncer-

¹⁰⁶ Under the absolute priority rule, senior creditors being asked to absorb equity risk would need to be given sufficient compensation when things go well to offset the risk that there will not be enough to pay them in full if things go badly.

¹⁰⁷ The preferred stock will have an appropriate “pay in kind” coupon that accrues during the “waiting period.” It will be redeemable at par plus accrued during the waiting period, and convertible into substantially all of the reorganized company’s common stock at the end of the waiting period. If the value of the enterprise turns out to be higher than the banks expect, the security should trade close to par based on its priority, its coupon and the high likelihood of eventual redemption. This is in fact what occurred in the Consec case. The enterprise value proved to be far greater than the principal amount of the pre-reorganization senior debt, and the convertible preferred stock issued to the senior creditors traded close to par until it was redeemed at par plus accrued dividends approximately [2 years] after issuance. See Consec, Inc., *Consec to Redeem All Issued and Outstanding Shares of Class A Senior Cumulative Convertible Exchangeable Preferred Stock*, May 12, 2004 available at www.consec.com/consec/selfservice/about/cnews/news.jhtml?newsId=ins_20040512_1&cat=cnews; Consec Inc., 2004 Current Report (Form 8-K), at 2 (May 12, 2004). If the value of the enterprise proves to be at or below the amount of senior debt, the preferred stock should trade at a value based on the assumption it will not be redeemed but instead converted into common stock at the end of the waiting period. Its value would then be dictated by the expected value of such common stock at the end of the waiting period.

¹⁰⁸ For a discussion of the virtues of using multiple appraisers in bankruptcy valuations, see Scharfman, *supra* note 80.

tain. This “option” results not from the lack of a commitment to the principle of absolute priority, but from being in a world in which the value placed on the business by an unbiased judge may well be higher, and perhaps substantially higher, than the business could be sold for in the market place. In our example, the banks believe American Instruments’ business is worth only \$250 million, but they do not believe it could be sold for that amount today nor would they favor a sale today. They also believe that, absent a sale, the court’s valuation could be substantially higher than \$250 million. In these circumstances, they are better off postponing the day of reckoning and allowing the bondholders to participate if the business does unexpectedly well.

V. Concluding Thoughts

As we have seen, in large business reorganization cases, outcomes that are commonly considered departures (or “deviations”) from absolute priority are often something else entirely. They can be rational, voluntary settlements made in the shadow of the absolute priority rule when the outcome of the court’s appraisal of the business (and, indeed, the value of the business itself) is uncertain. Where the business is not sold, Chapter 11 plan negotiations are heavily influenced by the parties’ different beliefs about the value of the business and of the likely outcome of and variance associated with the court’s valuation. The settlement negotiations that take place in the context of these uncertainties are like any other litigation settlement negotiations in that they will truncate litigation only if a bargaining range exists. Both senior and junior investors must view themselves to be better off reaching a settlement than they would be moving forward with a valuation hearing and letting the Chapter 11 process run its natural course.

That the junior investor often takes options, warrants, or other securities whose value is contingent on the future performance of the business is to be expected as well. When parties have different beliefs about the value of the business, such plans expand the bargaining range and make settlements possible that might not have been otherwise. What appear to be departures from absolute priority are merely the settlements we should expect in the shadow of a well-functioning system of adjudication.

The phenomenon is not a new one. Consensual recapitalizations in the face of uncertain valuations raise the same issues today that they did in the era of equity receiverships. For the same reasons as today, in the equity receiverships of the late 19th and early 20th centuries, senior investors often agreed to forego an actual sale or a judicial valuation and allowed junior investors to participate who might well be out of the money if there were a day of reckoning and the value of the business was fixed. Two legal scholars, James Bonbright and Milton Bergerman, highlighted this behavior in a

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landmark 1928 paper in the *Columbia Law Review*.¹⁰⁹ They observed that senior investors in equity receiverships often allowed junior investors to participate in distributions despite the failure of senior investors to be paid in full. They rejected absolute priority and endorsed testing the fairness of the recapitalization plan against a standard of “relative priority” because that standard was more congruent with the investor behavior they observed.¹¹⁰

Following the publication of Bonbright and Bergerman’s paper, the debate over the proper legal standard for approval of a reorganization remained heated until the Supreme Court unequivocally adopted the absolute priority rule over a decade later.¹¹¹ Those who attacked relative priority saw no reason to grant “out of the money” junior investors participation in the reorganized enterprise, contingent or otherwise.¹¹² Rather than seeing such plans as a sensible way to settle in a world of uncertain valuations, critics saw advantage-taking by insiders (who tended to hold junior interests) of outsiders (who tended to hold senior claims).¹¹³ Because of perceived (and sometimes actual) abuses by insiders, the critics were blind to the possibility that senior creditors with the contractual right to priority might sensibly agree to grant contingent rights of participation to junior investors in a world of valuation uncertainty.

Modern bankruptcy academics who criticize “deviations” from absolute priority have been equally blind to the possibility that such departures might be attributable to something other than manipulation of the process or bias of the courts. They ignore the fact that any regime that relies on appraisal as the default method of resolving reorganization entitlements must contend with appraisal variance as a necessary by-product. Such systems grants junior investors something of value to sell that senior investors sometimes want to buy—the right to insist upon a day of reckoning in which the judge collapses future uncertainties to a discrete value. This right commands a price in the marketplace. Moreover, a coin that senior investors value relatively little (some form of option that takes into account the

¹⁰⁹ See generally Bonbright & Bergerman, *supra* note 17.

¹¹⁰ Bonbright & Bergerman, *supra* note 17, at 130.

¹¹¹ Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939).

¹¹² See, e.g., Jerome N. Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 VA. L. REV. 541, 541–42 (1933)

¹¹³ See, e.g., William O. Douglas & Jerome Frank, *Landlords’ Claims in Reorganizations*, 42 YALE L.J. 1003, 1012–13 (1933); SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, Part I–VIII (1937–1940) (written under the direction of William O. Douglas).

low probability that the business will ever be worth much) is one that the junior investors may value peculiarly highly.

From a perspective over seventy-five years distant from Bonbright and Bergerman's original work, it appears that their work was closer to the mark than much that has been written since. Bonbright and Bergerman recognized that the prevailing practice (one in which there was "relative" as opposed to "absolute" priority) did not necessarily reflect a substantive entitlement that departed from absolute priority.¹¹⁴ Settlement behavior merely reflected pragmatic negotiated solutions when valuations were uncertain,¹¹⁵ avoiding the risks and costs of a full-dress valuation of the business.¹¹⁶ Bonbright and Bergerman felt the legal rule for approving such settlements should conform to the bargains actual investors seemed to want to strike in the real world.¹¹⁷

The idea of absolute priority grew out of real estate foreclosure law contemplating an actual sale of the asset for cash. Respecting the right of a mortgagee to be paid first is easy when there is an actual sale that creates a pile of cash. It is not so easy when there is no cash sale and some other mechanism must be used to value an operating business. For this reason, Bonbright and Bergerman concluded absolute priority was "not well adapted to the corporate form of organization,"¹¹⁸ and that a rule of relative priority, consistent with observed settlement behavior, was more sensible as a response to the problems of the financially distressed corporation. If the fairness of a reorganization were measured by a relative priority benchmark, no single party could block a settlement by insisting on payment in full. Instead of the reorganization day becoming the day of reckoning (requiring an uncertain and costly valuation), the parties would be able, without unanim-

¹¹⁴ Bonbright & Bergerman, *supra* note 17, at 131-33.

¹¹⁵ See, e.g., Robert T. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 COLUM. L. REV. 901, 912 (1927) ("Mathematical exactness is not required and is not possible. Reasonable adjustments are encouraged. Every reorganization plan of necessity represents a compromise.").

¹¹⁶ See Bonbright & Bergerman, *supra* note 17, at 161 ("[T]he adjustment of the claims of the various classes of securities on the basis of relative position rather than on the basis of a wiping out of equities effects an escape from the difficult, nay almost impossible, task of estimating in advance the probable values of the securities of the reorganized company in order to determine how much and what kind of securities must be offered to the senior bondholders to fully indemnify them for their investment in the old bonds.").

¹¹⁷ Bonbright & Bergerman, *supra* note 17, at 165.

¹¹⁸ See *id.*

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ity, to implement a reorganization settlement that recognizes the option value the reorganization process sometimes affords the junior interests.

Despite Bonbright and Bergerman's expectations to the contrary, the absolute priority rule was adopted as the standard for approval of a business reorganization (as the interpretive gloss on the "fair and equitable" standard carried forward in Chapter X of the former Bankruptcy Act).¹¹⁹ Its adoption precluded senior investors from buying out the option held by junior investors even when the vast majority of senior investors wanted to. Modern Chapter 11, in contrast, while embracing absolute priority unequivocally as the ultimate substantive rule, encourages consensual relative priority plans. One of the key reforms effected by enactment of the Bankruptcy Code in 1978 was to permit bargains to be struck by a statutory majority of senior investors waiving enforcement of the absolute priority rule.¹²⁰ By providing an easier path to consensual relative priority plans against the backdrop of the absolute priority rule, the Bankruptcy Code achieved the very balance that Bonbright and Bergerman sought to achieve through a substantive standard of relative priority.

Bonbright and Bergerman instinctually understood what it took almost 50 years for Congress to recognize: a reorganization system based on subjective valuation rather than monetization of the business in the marketplace often leaves senior investors worse off even if the ostensible objective of the valuation is to enforce absolute priority. Bonbright and Bergerman embraced relative priority as a substantive rule because the negotiations that now take place in Chapter 11 were more difficult in a world in which unanimous consent was required and a single senior creditor could insist on payment in full as a condition of allowing the entire plan to go forward. They merely failed to recognize that the real impediment to accomplishing their goal was not the legal standard, but rather the unanimity requirement that permitted holdouts to block reorganizations favored by the vast majority of investors.

Taken in this light, the debate about absolute versus relative priority should not exist at all. We live in a world in which the absolute priority rule is flourishing, but an important feature of such a world—and that one that over 75 years of scholarship has misunderstood—is that relative priority plans exist, they are the norm in such a world, and they are fully consistent with absolute priority as a substantive default rule where the bankruptcy

¹¹⁹ See Bankruptcy Act, Pub. L. No. 75-696, 52 Stat. 840, 883-905 (codified as amended at 11 U.S.C. §§ 501-676 (1976) (repealed 1978)).

¹²⁰ See Lawrence P. King, *Chapter 11 of the 1978 Bankruptcy Code*, 53 AM. BANKR. L.J. 107, 108-09 (1979).

system offers a reorganization option that contemplates a judicial valuation as the means for enforcement of the rule. One may ask whether the impact of valuation uncertainty, inherent as it is in a system that relies on judicial valuation, is an unacceptable anomaly and whether some other procedure would be a better one. If, however, investors continue believe that reorganization of a business sometimes affords them a better outcome than selling it, it is difficult to see any alternative to the appraisal model as long as we believe it impractical to require junior investors to buy out senior investors to preserve the option value of their own position. We can create better appraisal mechanisms perhaps, but departures from absolute priority will persist. Relative priority settlements are inevitable in every appraisal regime.

The negotiated plans of reorganization that we see today in the case of large troubled businesses are by and large consistent with what we should expect to see in a world in which bankruptcy judges are unbiased experts who strictly respect bargained-for priority rights. What appear to be departures from this norm most often simply reflect the value of the option junior investors enjoy whenever the mechanism for establishing value involves a third-party appraisal. Critiques of Chapter 11 should begin by focusing not on whether departures from absolute priority are good or bad, but rather on creative mechanisms for implementing relative priority solutions in the shadow of the absolute priority rule.

Readers with comments should address them to:

Professor Douglas Baird
University of Chicago Law School
1111 East 60th Street
Chicago, IL 60637
douglas_baird@law.uchicago.edu

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